CHINA'S

GEOECONOMIC STRATEGY

SPECIAL**REPORT**

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LSE IDEAS

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Executive Summary

Nicholas Kitchen, Editor, IDEAS Reports

As the world continues to experience the fallout from the 2008 financial crisis, it is increasingly turning towards China. The outsourced 'workshop of the world' has become the world's great hope for growth, and the source of the capital the West's indebted economies so desperately need. Simultaneously, and in the United States in particular, commentators and policymakers have increasingly voiced concerns that the economic clout of a communist superpower might pose a threat to the liberal world order. These contradictory impulses – China as opportunity and China as threat – demonstrate one clear truth, exhibited in the Obama administration's much-trailed 'Asian pivot': that China is important.

The pace of China's integration into the world economy, as well as the relatively closed nature of China's government and society, means that whilst China's economy may have opened up, our understanding of what drives China's foreign and economic policies remains limited. Moreover, China's apparent adherence to Deng Xiaoping's code of caution and camouflage makes the task of throwing a light on China's international role even more difficult, an opacity which underpins the more alarmist assessments.

It is in this context that this report attempts to provide a systematic assessment of the economic bases of China's foreign policy and the challenges the country faces as it makes the transition from rising power to superpower. In doing so, it is informed by a central question, of to what extent China's remarkable growth has given rise to a geoeconomic strategy for China's future.

The answer, in short, is that China's foreign economic policies are not the result of a coherent, directed strategy. China's leadership understand the overarching need to rebalance China's economy, both domestically and internationally, in order to sustain growth and secure the country's continued development. But beyond this overarching goal there is little evidence of a plan as such; instead, particular domestic priorities and politics drive China's policies, often in contradictory directions.

Nowhere is this more marked than in China's military build-up and increased strategic assertiveness within its own region, marked by a series of incidents in which the competing impulses of a variety of domestic actors played a greater role in the crafting of policy than a strategic consideration of diplomatic interests. This haphazard approach, as Jonathan Fenby demonstrates, is having the paradoxical effect of reinforcing the ties of American hegemony in the Asia-Pacific.

Not only is China not conducting a coherent geoeconomic strategy, it is often not in direct control of the policies it has, even in so important an area as access to resources, as Shaun Breslin's analysis shows. Nor is China necessarily that competent in the international economic arena, as demonstrated by the decidedly mixed record of its firms' international investments. Significantly, these failings of foreign-economic policies are increasingly producing diplomatic difficulties for China.

This analysis suggests that ascribing a strategic plan to China – whether for the purposes of opportunity or threat narratives – is misplaced. China is attempting to come to terms with its integration into the world economy, its importance within that economy, and the pressures and responsibilities that emerge from those distinctly political realities. China's foreign economic policies, and in particular how it goes about rebalancing, will shape the world economy in the years ahead, and understanding the sources of those policies will be central to good policymaking in the West. As the analysis here shows, China's leadership is pragmatic, but it is also subject to significant and conflicting pressures both domestically and internationally. There are signs that China is beginning to reconcile itself to its role within the global economic system, particularly on issues such as trade governance, but it is by no means clear that China is willing or capable of using its position to strategically reshape that order. Ultimately, as Arne Westad points out, China's international role will be determined by what happens within China, and how China's leaders mitigate the political consequences of economic rebalancing. If they succeed in doing so, China's geoeconomic strategy need no longer be the source of so much diplomatic debate. ■

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China’s Geoeconomic Strategy

China's International Future

Odd Arne Westad

Over the past two decades China has become integrated in the world economy to an extent unprecedented in the country's history. When foreign investment returned to China in the early 1990s, after the shocks of the Tiananmen events, it was at a pace and level never seen before. The combination of a dedicated and cheap workforce and the hope of buying into China's own domestic development led to the country leap-frogging all others in terms of foreign direct investment (FDI). Over the course of the whole decade China was second only to the United States in attracting FDI – a remarkable change, given that foreign investment of any kind had not existed in China prior to 1980. Up to today the changes in China's economic system have to a large extent been driven by the needs created by foreign investors. For instance, a legal framework of ownership had to be created to serve those who wanted to invest in China. The same framework could then serve China's own embryonic capitalists. Similarly for stock exchanges, insurance arrangements, and quality control. China's bid to join the World Trade Organisation (WTO), which finally succeeded in 2001 (very much thanks to the goodwill of the United States), was intended to serve China's export potential, but also made the country sign up to stringent regulations concerning state subsidies (or rather the absence thereof), industry standards, copyright protection, and not least opening the Chinese market to foreign competition. The international drove the domestic in terms of economic change.

By 2000 the socialist economy in China had lost out to a market economy encouraged by a party dictatorship that was still Communist in name. For China's population it was clear that they were living in a new society in which market forces were dominant. State-owned enterprises were sold off, downscaled, or allowed to go bankrupt (at least 5,000 such companies have gone bankrupt each year since 2000). Those that survived are publicly listed and under the same management regulations as all other Chinese companies. For ordinary people this rearrangement means that employers that may not have paid them much money, but otherwise looked after them and their children from the moment the state assigned them to the factory to the day they died, were now a thing of the past. No more free healthcare, kindergartens, schools, housing, holidays, or homes for the elderly. Instead, people had to – gingerly – enter a private housing market, search for a good job, and save for their children's college education. Millions of people had to travel elsewhere to find work. China's capitalism, when it finally broke through in the 1990s, was very unlike the European and the Japanese variants, with their safety nets and entitlements, but remarkably like that of the United States, with its emphasis on mobility, opportunity, and personal responsibility.

But it was not only the Chinese population that had to learn a new way of living in the 1990s and 2000s. The state had to learn, too. Having given up direct ownership of the economy, it had to create new instruments of indirect control, most of them borrowed whole-sale from the West and based on legislation, regulation, and fiscal and monetary policy. It was, in many ways, a return to China's preoccupations of the inter-war period, only with a much larger segment of the population involved in the industrial economy. Some critics called it a counter-revolution, since the state increasingly saw its main task as serving market-led economic growth.

By the 2000s the Chinese Communist state had adopted concerns about inflation, interest rates, credit flows, and property rights that sounded very similar to those of Reaganite America or Thatcherite Britain in the 1980s. Capitalism was in the driver's seat, even if CCP leaders would not admit it, and the role of the state in advanced capitalist economies – minus electoral democracy – was what Beijing was aiming for. China's capitalist revolution of the past twenty years has brought the country closer to the outside world – and especially to the United States – in terms of the aims many people set for themselves or how the Chinese state operates than ever before, or at least since the Mongol dynasties of the thirteenth century.

Why did the party do it? Founded on an anti-capitalist creed in a China in which many people – not only Communists – felt that capitalism had brought nothing but suffering, exploitation, and humiliation, the move from Maoism to market demanded a remarkable turn-around not just in ideology but also in mentality. For critics of the CCP inside and outside of China the answer is simple: the party's much lauded 'flexibility' was a consequence of its long history of manipulating the truth and deceiving those who believed in it. Party leaders embraced capitalism to enrich themselves and their families, and because the plans for the future they had once promoted had utterly failed. There is obviously some truth to these presuppositions, but they are far from the whole truth. The main reason why the CCP chose the market was that from the position of the early 1990s there seemed to be no other way out. Modernity was capitalist. The USSR had – very unexpectedly for the Chinese – collapsed, as had the socialist states in Eastern Europe. The United States led the way towards an increasingly integrated capitalist world economy, and those who opted out of it would fall behind. The risk of falling behind was what first and foremost animated China's leaders from Deng Xiaoping to Hu Jintao. If the race to modernise could be better run with Nike trainers, then the Chinese Communists would put them on (especially if the shoes themselves were made in China).

A new generation of returned students played a big role in China's capitalist transformation. Even though a very large number of Chinese who had studied abroad wanted to remain abroad in the 2000s, those who did go back to China had the expertise and the status to begin introducing new practices, first, in private enterprise, and, second, in the state and even in the party. By the late 2000s one could get the impression that the CCP itself had taken over many of the management methods of foreign enterprises: quantifiable results for young party brass were all the rage among the top cadres of the party. One high-level CCP member described his training at the party academies in terms that anyone with a MPA or MBA from Harvard or LSE would recognise. At the same time foreign educated academics are transforming China's own higher education. Research output is crucial to promotion, and the output is supposed to be of international standard. Student concerns are increasingly taken seriously by their professors (since they are paying customers). When party control and academic ambition collide, it is as often the latter that wins out as the former.

While consumer choice meant nothing in China before the late 1980s, it now means a lot to most Chinese, even those who live far from the main cities. The preoccupations are very similar to those of the pre-World War II era: how can modernity – preferably of an international kind – be best expressed in terms of products. Young people in China today are among the most fashion- and brand-conscious in the world. Foreign-produced goods generally have the edge, even though some Chinese brands are beginning to catch up. Music is often American, with liberal doses of Canto-pop thrown in. Clothes styles and hair styles are Western, mediated through Hong Kong and Taiwan. For other products, concerns such as environmentalism or sustainability are beginning to find their way in, but not on key issues that really matter to the Chinese consumer, such as buying a car. In China – the world's largest market for new cars in 2010 – the American habit of buying the biggest engine your pocketbook can afford is still the rule (with predictable consequences: China today has twenty of the thirty most polluted cities in the world).

At ground level, mass consumption is only one part of China's capitalist revolution. The other is the way people invest in the new economy. The main aim for many in China today is to buy their own house or apartment. In the cities it can only be done through immensely hard work by a young couple, since property prices are almost at European levels and salaries are much lower. Even though the Chinese savings rate is still very high, more and more of it – within an extended family – contributes in one way or the other to paying off debt. Meanwhile more and more young Chinese are investing directly into the market, and often find that with some sense added to the general expansion that the Chinese economy has gone through their investment can earn them as much as their salary. All put together, Chinese investors – in property and stock – are becoming increasingly numerous, and – even though they are not likely to be more democratic or less nationalistic than their fellow citizens – they have, quite literally, bought into a development pattern for China that is quite similar to that of Western nations, or Japan or South Korea.

The one area in which China stands out from other East Asian states, including Taiwan, in terms of development is – ironically enough, given the pretensions of its Communist government – the matter of equality. While the early Communists had dreamed about a China which was modern and strong and socially just – and Mao had pursued the topic of equality endlessly in his campaigns – China today is one of the most socially stratified societies on earth. While more than a third of the population – those who have not joined the industrial economy – live on slightly more than $2 income per day, China has 128 dollar billionaires and half a million millionaires. Its Gini coefficient (the standard used for measuring levels of income inequality) is higher than that for any other country in its region, and just slightly lower than the most unequal countries on earth, such as Brazil. CCP leaders defend themselves by quoting Deng's maxim that some people have to get rich first, while presiding over increasing levels of inequality. Yet in some areas social unrest is rising, with local organisers claiming that the party is a tool of foreign exploitation of China. For minorities, in Tibet and Xinjiang but also in the south, the same party that tried to drown their identity in blood during the Cultural Revolution, now drowns it in consumer products and market adjustments, while increased mobility leads to ever more Chinese in minority areas. Capitalism, though victorious in China, is in no way uncontested.

The most remarkable story of China's international development over the past thirty years has been its re-engagement with the rest of Asia. Three decades ago China suffered a self-imposed exile from the continent of which it is a part. Its only close relationship was with North Korea, and even there Beijing had to compete for position with Moscow. As if this diplomatic isolation was not enough, China had territorial issues with all of its neighbours (North Korea included). It was an Asian world that seemed to have expurgated China from its midst. The central kingdom was no longer central; it was distinctly peripheral to the rest of the continent.

While the main reason for China's marginality was its own contrary politics, another key reason could be found in the strong economic gains made by other Asian economies while China's own economy stagnated. Japan had of course been the pioneer of development in the region, with substantial growth rates even in the early 20th century. But from 1950 to 1973 the Japanese economy grew by an average of 10 percent per year, as did Taiwan. Singapore, South Korea, and Hong Kong all grew at 8 percent. In China GDP per capita in 1973 was around $800. In Japan it was $11,500, in Hong Kong $7,000, in Singapore $6,000, and in Taiwan $4,000. China was falling further and further behind the leading economies in Asia, and even though most Asians would have liked to see China open up to their exports, they did not actually believe that it was going to happen at any point soon.

Compare this with the situation today. China's own economic growth since 1980 has been spectacular, averaging near 10 percent, and it has rejoined an integrated East Asian system of trade, finance, and investment. What is more, this growth has taken place in a country that has 1.3 billion people in it; more than double the population of the rest of East and Southeast Asia put together. The journey that China has been on over the past generation has been intimately linked with its relationship to its neighbours, first those next-door and then into the Southern and Western parts of the continent. Indeed, China's rise would have been impossible without it revitalising these links. China is now an economic powerhouse that all of the rest of Asia orients itself towards, and its policies on all matters are of crucial importance for the whole region.

The development of China's economy will be at the center of the country's international affairs for the next generation, irrespective of the twists and turns in its domestic politics or its diplomacy. The reason for this is not only that China is now the second largest economy in the world, but the roles it has taken on for this to be possible. China is today the world's workshop, the zone where things are made which then end up on the shopping lists of Americans, Europeans, and Asians alike, and which nearly everyone else aspires to possess. This is the country's current role, and it has achieved it by being willing to play the global market game according to the rules that were set up first by Britain in the 19th century and then by the United States in the 20th. In spite of its government's nominal Communism, China has in practice become the champion of free market capitalism, internationally if not always internally. It is working hard to take on the rules of the game and is increasingly concerned that others, be it in Africa or Europe, are themselves not always doing so. Seen from a Western perspective it is hard not to conclude that China is now 'playing our game.'

But as China emerges as the master player of international capitalism, it is also obvious that the rules of the game are being re-made in China. In spite of observations by sceptics, these sinified rules so far rarely go in the direction of corporatism or state-control, but, at best, in the direction of collective decisions and compromise, and, at worst, in the direction of corruption and nepotism. It is very unclear how Chinese capitalism is going to influence practices in other countries, especially in cases where there are great cultural differences with China. Given the massive amount of foreign investment that has flowed into the country over the past decade it is a given that over time Chinese financial practices will influence the foreign companies that do business there. But at the moment the Chinese are busy implementing foreign rules, for instance on managerial and labour relations, in ways that are profoundly changing Chinese society.

The Chinese government today wants to play a strong regulatory role in the development of the country's economy. Because China is a political dictatorship, all institutions, including private companies, pay generous attention to government instructions. But in reality the state's ability to influence private decision-making is limited, in spite of the repressive means at its disposal. In South Korea or Taiwan the regimes could set directions because they controlled credit and capital-flows, and because they – and only they – facilitated access to foreign markets. The amount of foreign direct investment in their industrialisation processes was miniscule, their credit companies were under state control, and their main firms invested nationally for export abroad. In China these crucial aspects of industrialisation are turned upside down. Foreign investment has driven significant parts of the process, foreign banks are operating in China and Chinese banks have plentiful means to resist government pressure, and the biggest Chinese companies have already become multinationals with large investments abroad. The domestic Chinese growth process since 1990 has not been governed by national priorities or five-year plans, but by the chaotic interplay of market forces. All of this has happened while the state has kept its investments in profitable industries, owning or part-owning many of China's biggest companies. But, as one economic planner told me recently, state-owned companies are increasingly behaving like privately-owned companies in the market; they recruit their managers from the same pool of talent and they are equally responsible for profits and losses. They may listen to what the government says, but only if it provides a sound bottom-line for their company.

At the moment quite a few global investors and corporate executives agree that China will re-invent global capitalism rather than ruin it. In the wake of the crisis of 2008/09, Chinese officials and businessmen alike began lecturing Western countries on the need for market and currency stability, and for avoiding corporate greed, bad loans, excessive deficits, and extravagant consumption. Some of this sounds laughable, given the amount of bad business practices in China itself. But it does signal that many elite Chinese now see themselves as stakeholders in an international economic system, on the success of which their futures depend. Many people in China (and quite a few outside) dream about a future Sino-capitalism that will be better organised, more balanced, and less destructive than its Western inspirators. So far there is little that tells us that will be the case. But, as has often happened in the world economy before, those who are the generators of global growth innovate as well as imitate. Future Chinese leaderships, public and private, may be stimulated by the crises they have gone through to opt for more regulation and government design than we have seen in previous versions of world capitalism.

The 2008/09 global financial crisis also showed a China that had arrived as a key player in the world economy. At the World Economic Forum in Davos in 2010, Chinese Premier Wen Jiabao placed the blame for the crisis on the 'inappropriate' macroeconomic policies of Western countries 'and their unsustainable model of development characterised by prolonged low savings and high consumption; excessive expansion of financial institutions in a blind pursuit of profit; lack of self-discipline among financial institutions and rating agencies and the ensuing distortion of risk information and asset pricing; and the failure of financial supervision and regulation to keep up with financial innovations, which allowed the risks of financial derivatives to build and spread.' Quite a handful: the apprentice was taking the past masters to task for their excess. But the medicine the CCP itself prescribed did not imply that there was anything wrong with capitalism as such; instead it implemented the largest stimulus program of government spending in history, thereby attempting to stave off the worst consequences of the crisis for Chinese companies and for the Chinese population. Post-crisis growth for China will most likely not be of the same scale as before, because of international competition and, eventually, the country's aging population. But even with 'only' six percent annual growth on average, China will probably still become the world's largest economy sometime in the mid 2030s.

China's international position in the 21st century will be determined as much by what happens inside China as what happens outside its borders. The country's biggest domestic problem is that uneven growth has left large regions behind and that the lack of a proper welfare system and protection for workers against exploitation has led to an extremely high level of inequality. While Premier Wen and others are lambasting the West for its excesses, inequality in China is at least twice as high as in the United States or Britain, with higher ratios to relatively equal societies such as Germany or France. While slowly and uncertainly trying to deal with its worst consequences – for instance by re-introducing some forms of subsidised education and health care – the Chinese government is defending itself by continuing to make the argument that 'a rising tide lifts all boats'. The problem is that there are no signs that Chinese inequality is abating; on the contrary, the situation in the poorer regions is getting worse and worker unrest over low pay and atrocious working conditions in many factories is on the increase.

In spite of receiving credit for China's overall economic growth, there is little indication that the CCP as a party is capable of dealing with some of the social tensions this growth is creating. The party's steady refusal to allow increased political pluralism, which could have acted as a safety valve against discontent, will make Chinese politics more unsettled over time. The CCP today is unable to act with massive brutality against its own urban population, as it did during the Mao era, not least out of fear that such atrocities could unsettle the country's economy. A leading party member told me that he thought that even a repeat of 1989 would be unthinkable now – 'just imagine,' he said, what would happen to the country's credit rating!'. But at the same time the party's leaders gamble all on economic growth keeping their people from taking action against them. Such gambles rarely pay off.

A main reason why China is viewed with such suspicion abroad is that it is led by a Communist party. But today's Chinese regime is a far cry from Communists of the past. In reality, the regime itself has become much more like what Taiwan or South Korea were before democratisation – authoritarian, and sometimes ugly and brutal, but not capable of atrocities on the scale of those of the past, even in its own defence. While it is impossible to predict what will happen in Chinese politics, I would not be surprised if China follows a similar pattern of democratisation to the other main states in the region, only stretched out over a longer period of time. Whatever happens, the CCP will not be around forever, and those foreign observers who today equate the party with the country are making a major mistake: history shows that China is as capable of political change as it has recently been of economic and social change, and there is no set of engrained 'values' or 'attitudes' that will necessarily put the country at odds with its neigrbours or with the West. As before in its history, China's direction will ultimately be a matter of its leaders' political choice. ■

Does China have a Foreign Policy? Domestic Pressures and China's Strategy

Jonathan Fenby

As China approaches its wholesale change of leadership starting later this year it faces as wide a set of challenges as any country on earth. The scale and speed of its material rise over the last three decades has been such that it is all too easy to overlook what has not been done, and to exaggerate the extent to which the People's Republic (PRC) is ready to become the dominant global force.

The idea of China's exceptionalism, the notion that it has forged a new, self-sustaining model has a lot of holes in it; indeed, some of China's top leaders, including the outgoing Prime Minister, Wen Jiabao, admit to its flaws. That will not deter those who welcome the prospect of the last major state of earth ruled by a Communist Party overtaking the United States as the most influential player on the world scene. But, as Guy de Jonquières shows in his paper, the PRC has to be viewed in a context of global interdependence.

Chinese leaders are well aware of this; hence, for instance, their concern about a recession in Europe and its effect on exports. But their greatest concerns are domestic. Political reform is on the back burner and, given that it would entail the Communist Party submitting itself to external controls, legal reform is unlikely to make much progress in a nation where rule by law has always prevailed over the rule of law, and where the draconian gospel of Legalism has lain within the softer glove of Confucianism. The main debate is instead about economic reform and the extent to which the need to re-shape and re-balance the economy will affect existing structures and the position of vested interest groups.

FRAGMENTED POLICY MAKING

In this context, foreign policy takes a secondary position in the PRC's priorities, and is complicated by the involvement of different power centres. The Foreign Ministry appears weak. State Councillor Dai Bingguo, who derives his authority from the Communist Party's Leading Group on Foreign Affairs, outranks Foreign Minister Yang Jiechi. A constellation of interest groups affects policy, including the powerful Commerce Ministry; state-owned enterprises; the energy and metals lobbies; the security and ideological arms of the Party, which want to keep 'harmful' foreign influences at bay; and the People's Liberation Army (PLA).

At first sight, it may appear that China has quite a clear approach to the world. It has defined its 'core interests', including the preservation of its existing political and economic system, and territorial unity that includes Tibet and Xinjiang and the claim to Taiwan. Linked to this, it upholds non-interference in the internal affairs affairs of sovereign states. It pursues a 'resource diplomacy' aimed at ensuring the supply of raw materials. For much of the period of growth since the end of the 1970s, it has applied

Deng Xiaoping's doctrine of 'biding time and hiding one's talents' in international affairs while building up the economy, and avoiding causing alarm among developed nations which it needs both as export markets and as a source of technological investment.

But this collection of separate interests contains internal contradictions and hardly constitutes the foreign policy of a great power. All this leads to the question of whether Beijing has a coherent foreign policy or, rather, a series of different agendas pursued at different times in different ways by different actors.

In international security, Beijing's see-saw line over Libya saw it refuse to veto the no-fly zone and then subsequently upbraid France for taking action against Gaddafi. Syria has provided another example of China's hesitant diplomacy, as it struggles to reconcile its interests and sovereigntism with its position as a system-making great power. As for resources, it is unclear that the pursuit of yet more agreements on the supply of minerals and oil can be pursued without strategic implications. At some point Chinese investment, notably in Africa but increasingly also in Latin America, will take on a political aspect as local populations raise questions about the PRC's presence.

When it comes to the international financial system, Beijing speaks of the need for reform and bridles at the domination of Western nations. But it is yet to present an alternative programme beyond the call for greater use of Special Drawing Rights by the Governor of the central bank, which one source says was not authorised by the government and faces huge difficulty in being accepted. Its currency policy is dominated by domestic concerns. On the wider global stage, China may be seen as the leading member of the BRIC nations, but their collective inability to act as one in a positive direction was shown most recently by their failure to line up behind a common candidate to compete with the US nomination for the Presidency of the World Bank.

THE PACIFIC PIVOT

Over the past two years, China's regional conduct in East Asia has led to tension with neighbours and to Washington deciding to pursue a policy of a 'Pacific pivot', strengthening its security presence and seeking wider trading arrangements. This can hardly be to Beijing's taste, but the PRC has brought much of this on itself with the series of incidents pitting Chinese boats against vessels from Japan, South Korea, Vietnam and the Philippines – plus strong rhetoric from hawks in Beijing and a minor military build-up round the South China Sea. The Obama administration has predictably seized the opportunity to raise the United States' profile in the Pacific, leading to modulation of Chinese policy which, however, shows signs of fissure before it has been properly implemented.

The PRC presents itself as anxious to step up cooperation in East Asia. But its fishing trawlers have been involved in a succession of maritime incidents with other regional nations, as shown in figure 1. Some have taken place off the coasts of Japan and South Korea, and China has an ongoing dispute with Japan over ownership of a group of uninhabited islands in the East China Sea. However, the focus for most of these disputes is the 1.3 million square mile South China Sea through which 60,000 ships pass each year. The Sea is estimated to provide 10 percent of the world's supply of fish and also contains rocky islets that may sit on top of valuable oil and gas reserves.

On the basis of a map dating from 1947, the PRC insists that it has sovereignty over the whole South China Sea. However Vietnam, Malaysia, the Philippines, Brunei, Indonesia, Singapore and Taiwan have claims too. The main confrontation is between China and Vietnam and the Philippines. Vietnam claims that its exclusive economic zone stretches 200 nautical miles from its coast, and has granted Exxon-Mobil a licence to explore three offshore oil blocks. India's state-owned Oil and Natural Gas Corporation (ONGC) is also planning to drill in a block off Danang, leading the Foreign Ministry in Beijing to warn that 'any foreign company that engages in oil-exploration activity in waters under China's jurisdiction without the agreement of China has violated China's sovereignty, rights and interests. This is illegal and invalid.' Although Japan and

South Korea are not claimants to the sea, nearly all their oil imports arrive by that route and Japanese firms are exploring for oil off Vietnam.

China's three regional naval fleets held joint manoeuvres in the South China Sea for the first time last year. To the north, where Beijing and Tokyo dispute ownership of the Rikuyu Islands in the Yellow Sea, Japan, Taiwan and the US have all reported Chinese submarines at increasing distances from the Mainland. China's navy sent 10 vessels into the Pacific through the strait between Okinawa and the island of Miyako for exercises in June, and the Defence Ministry announced in November that the navy would conduct regular exercises in the western Pacific. Chinese coast guard craft have stepped up patrols in disputed waters and China began to fly PLA surveillance drones over the East China Sea close to the Korean coast at the end of November. Beijing dispatched a 'fishing enforcement ship' to the disputed Paracel Islands in September 2011 in order to 'safeguard maritime sovereignty and fisheries interests'.

On the diplomatic front, China temporarily cut off top-level contacts with Tokyo, and continues to restrict supplies of rare earth minerals to Japan following the arrest of a Chinese trawler captain in a clash with coast guards in 2010. The state news agency, *Xinhua*, greeted the appointment of Yoshihiko Noda as Japan's Prime Minister last September with a list of instructions to respect PRC interests, especially over disputed islands, to 'acknowledge China's legitimate requirement for military modernisation to defend its growing national interests' and to 'stop viewing China as a threat and call off the dangerous practice of invoking China's rise as an excuse… for military expansion'.

CHINA'S MILITARY BUILDUP

These confrontations come as the PLA is steadily building up its military spending with double digit increases in annual budgets. China accounts for 6.2 percent of global military spending, compared to 43 percent for the US, which is far ahead technologically. The PLA is working on a stealth aircraft, anti-satellite rockets and improved communications systems, but the main thrust of expansion has been at sea, where China currently has only 80 surface vessels (including a single aircraft carrier) and 70 submarines. Hu Jintao underlined the navy's role when he called in early December for it to 'make extended preparations for military combat'. A base for attack and ballistic missile nuclear-powered submarines has been built at Sanya on Hainan Island. An anti-ship missile that NATO dubs 'the Sizzler' and that can be launched from submerged submarines is reported to fly at three times the speed of sound over a 200-mile range. Another missile, the Dongfeng, is being developed to hit an aircraft carrier 2,000 miles away. The fleet air arm is being expanded to 200 aircraft.

Though the Mainland insists on its 'peaceful rise' and prefers 'asymmetrical' strategy to an arms race with the US, PLA hawks regularly rattle their sabres. General Liu Yuan, Political Commissar of the General Logistics Department and a Communist Party Central Committee member, wrote last year that 'history is written by blood and slaughter'. The main nationalist voice, the Communist Party tabloid *Global Times*, has called Vietnam and the Philippines 'little countries' which should 'get ready to hear the sound of gunfire' if they dispute Chinese sovereignty over the South China Sea. The headline of an editorial in the newspaper read 'China Cannot Resort Only to Negotiations Over Maritime Conflicts, We Must Kill One to Deter One Hundred If Necessary.'

No one should doubt China's desire to expand its naval presence in East Asia and to break through the island chain stretching from the south of Japan through Taiwan to the Philippines. *Xinhua* has added a claim to the whole of the South China Sea to the list of the PRC's 'core interests'; and the People's Daily, the main Communist Party mouthpiece, wrote on 23 November 2011 that 'there is no international water in the South China Sea'. *Global Times* warns of the threat of 'East Asian countries benefiting from economic cooperation with China as much as possible while containing China's influences by either joining with the US or forcing China to make concessions on disputed issues'. General Luo Yuan of the PLA Academy of Military Science has said that Washington is pursuing a containment policy towards the PRC and

Table 1: Maritime clashes involving Chinese vessels, 2010-12

Date/countries involved	Nature of incident	Outcome
April 2012 Philippines	Philippines naval vessels confront Chinese trawlers in waters claimed by Manila.	Chinese withdrew.
December 2011 Japan	Coast Guards arrest Chinese trawler captain for fishing in Japanese waters.	Muted Chinese response, with consul in Nagasaki calling for safety of Chinese fishermen to be respected.
December 2011 South Korea	Chinese trawler captain stabbed South Korean coast guard officer to death after a fishing boat was boarded 55 miles off South Korea's coast.	Unresolved.
November 2011 South Korea	South Korean Coast Guards seized a Chinese fishing boat and its crew for poaching inside South Korea's exclusive economic zone off Cheju Island. When a fleet of 25 Chinese boats gathered to demand its release, two more Chinese fishermen were detained.	Boats and men still being held.
November 2011 Philippines	China tells Philippines to halt oil and gas exploration 50 miles off Palawan province.	Manila refuses, saying the area is within its waters.
November 2011 Japan	Japan arrested a Chinese fishing boat captain for refusing inspection in Japanese territorial waters.	Captain released.
July 2011 Vietnam-India	A PLA vessel issued a radio warning to an Indian navy ship after its port visit to Vietnam.	Beijing later denied the incident.
June 2011 Vietnam	Chinese patrol boats seized equipment and fish from Vietnamese trawlers.	Vietnam protested. Anti-Chinese demonstrations in Hanoi.
May 2011 Vietnam	Hanoi said Chinese patrol boats harassed PetroVietnam exploration vessel and cut its cables 120 nautical miles off Vietnamese coast.	No response from China.
March-May 2011 Philippines	Manila reported maritime clashes with Chinese boats including harassment of one of its exploration ships off the Spratley Islands. PRC patrol boats and a Philippines-licensed oil survey ship played cat-and-mouse for two days in international waters. Manila reported Chinese construction work on Mischief Reef in waters claimed by the Philippines.	Manila protested. China gave assurances of goodwill to President Aquino when he visited China.
March 2011 South Korea	A Chinese fishing boat rammed a South Korean coast guard patrol vessel, injuring several officers. The two crews fought with axes and shovels and the South Koreans shot one of the Chinese fishermen in the leg.	The Chinese boat escaped.
September 2010 Japan	A Chinese trawler clashed with Japanese Coast Guard boats off uninhabited islands in the East China Sea claimed by both nations. The arrest of the ship's captain led to a diplomatic row, with demonstrations in China.	Captain released.

calls the US 'a deliberate spoiler, fishing in troubled waters'. *Xinhua* has also accused Washington of seeking to impose Cold War dominance in the region.

This leads some American commentators, such as Robert Kaplan of the Center for a New American Security, to depict China as an expansionist power akin to Germany before the First World War, as it banks on US decline in order to enable it to project its power. The reality is that China knows its military limitations and increasingly recognises the economic benefits to be gained from softer diplomacy. As Admiral Mike Mullen, the outgoing Chairman of the US Joint Chiefs of Staff, has said, Beijing's aim is to increase 'access denial' to American forces in the region rather than to seek confrontation. Beijing may not relish the prospect but its policymakers know that the US will remain the principal military power in East Asia and that any serious attempt to challenge it will only drive other countries further into its arms.

This can be seen from the way that both Vietnam and the Philippines strengthened military links with Washington after incidents earlier this year. In the face of China's new assertiveness, Japan and ASEAN agreed at the end of September 2011 to formalise maritime security cooperation. The South China Sea was at the core of talks in late October between President Aquino of the Philippines and Vietnam's new President, Truong Tan Sang. A US congressional delegation visited the Philippines in the autumn to discuss how Washington could bolster its defence needs. Japan's Deputy Minister of Defence Kimito Nakae said tensions over the South China Sea would require more cooperation with the US and India. Japan and the Philippines have affirmed their nations' security links in a 'strategic partnership', and the Philippines brought into service its largest ship, a 3,400-tonne cutter acquired from the US, which was deployed in the confrontation with Chinese trawlers in April, 2012. Manila plans to buy one more similar craft as well as acquiring second-hand fighter jets from Washington. Meanwhile Taiwan is strengthening the defence of one of the Spratley Islands that it holds.

Vietnam is due to get six Kilo-class submarines from Russia, which also supplied it with two Gepard-class guided-missile frigates this year. Hanoi is negotiating for two more frigates, with anti-submarine weapons. It also has two batteries of Russian Bastion land-based anti-ship cruise missiles and an undisclosed number of Sukhoi Su-30 jet fighters. Vietnam signed its first defence agreement with the US this year. The US aircraft carrier *George Washington* paid port visits to Vietnam this year and American naval ships have been repaired recently in Cam Ranh Bay.

RE-ENTER THE US

Having drawn the conclusion that China's assertive approach was proving counterproductive, the Obama administration embarked on a forward policy to show that, in Secretary of State Hillary Clinton's words, 'the 21st century will be America's Pacific century'. It has stepped up military cooperation with Vietnam and the Philippines and is starting to base troops in Darwin, Australia – only 250 at first but increasing to 2,500 over an unspecified timeframe. Japan is buying F-35 fighters from the US and, in December 2011, the State Department announced that Japan, India and the US had held the first of a series of trilateral security talks on Asian and global issues. All three nations took initiatives at the end of the year to improve relations with China's client state Burma, including a visit there by Hillary Clinton, the first by a US Secretary of State in 50 years.

Furthermore, President Obama used the East Asian summit in Bali in November 2011 to relaunch the Trans-Pacific Partnership (TPP), a proposal for a free-trade zone first mooted by Washington in 2009. Only four Pacific nations – Brunei, Chile, New Zealand and Singapore – have signed up to the TPP while Australia, Malaysia, Vietnam and Peru are negotiating for membership. Japan has said that it will join in talks on the scheme, but as it stands, the proposal looks more like a rhetorical device with an anti-China message than a serious new option for regional economic relations. The 'fast-track' trade negotiating authority that the administration would require seems unlikely to be forthcoming from Congress in an election year when defence of jobs will be a major campaign issue, and when important union supporters of the Obama campaign are hostile towards the proposal. Even if the US did join, the other eight countries, without Japan, encompass only five percent of US trade, and in spite of its close relationship with Washington, Japan is unlikely to participate because of opposition from its farmers and small businesses. The South Korean government is already having trouble getting its free-trade agreement with the US through the National Assembly. As for China, US National Security Adviser Tom Donilon made plain in an article in the *Financial Times* that the TPP would be run as Washington wished, insisting on 'high standards including on matters of intellectual property, labour and state-owned enterprises'.

CHINA'S DIPLOMACY TURNS

The PRC may not have too much to fear on the economic front. But it has clearly taken note of the hostile reaction its assertive behaviour has produced and has shifted to a more placatory approach. When the Japanese Coast Guard arrested a Chinese trawler captain for trespassing in Japan's fishing grounds at the end of 2011, China's response was limited to a statement by its consul in Nagasaki urging the authorities to ensure the safety of Chinese fishermen and to respect their legal rights – a sharp contrast with the top-level anger displayed in 2010. Similarly, its diplomatic protest when two local legislators from Okinawa visited disputed islands – known as Senkaku in Japan and Diaoyu in China – in January 2012 had a pro forma air to it.

At the East Asia summit conference in Bali in November 2011, Prime Minister Wen Jiabao bowed to pressure from other participants to have a multilateral discussion of the South China Sea rather than sticking to China's previous insistence that it would talk only bilaterally. The clash with Vietnamese vessels off Danang in summer 2011 was followed by a scheduled economic cooperation conference. Then Xi Jinping, the anointed next leader of the PRC, visited Vietnam in late December for talks at which, according to the Chinese, both sides agreed to work towards a consensus on the South China Sea.

Meeting in Beijing on Christmas Day, Wen Jiabao and Yoshihiko Noda agreed to promote direct trading of the yen and the renminbi without using dollars, and the Japanese delegation confirmed that Japan would apply to buy Chinese bonds in 2012. Concern about the stability of North Korea following the death of Kim Jong-il overshadows the anger in South Korea at the killing of a coast guard officer by a Chinese trawler captain in a maritime clash in mid-December. The deputy foreign ministers of the two countries held talks at the end of December with China's Zhang Zhijun calling for closer communication between the two countries to address the 'dynamics of the Asia-Pacific region' that were becoming 'complicated and serious'. Seoul's nuclear envoy Lim Sung-nam went to Beijing at the end of last year to discuss resumption of the stalled six-party talks on North Korea's nuclear programme, and at the same time, a state visit to China in 2012 by South Korean President Lee Myung-bak was announced.

The perennial tensions over Taiwan have eased since the Kuomintang returned to power in 2008, and the Mainland has pursued a softer approach that has brought the Republic of China increasingly into its fold. Prospects for the January 2012 Taiwanese presidential election have been clouded by the third-party candidacy of James Song of the People First Party, to challenge the incumbent Ma Ying-jeou and Tsai Ing-wen of the Democratic Progressive Party (DPP). Ma is still expected to win re-election, but even if Tsai defeats him, cross-Strait relations will probably not experience the tensions seen after the DPP victory of 2000. The Obama administration has made the limits of its backing for the island evident in its restrictions on sales of state-of-the art weaponry. Washington will continue its opposition to calls for independence for the island and stick to the ambiguous 'One China' policy adopted in the 1970s and embraced by Ma as well as by the PRC.

THE CONFLICTING STRANDS

China's new leadership under Xi Jinping, which takes over from this autumn, cannot turn its back on nationalist sentiment, and there is always the possibility of a military miscalculation. With the prospect of falling exports to the West, Beijing will be reluctant to do anything that could jeopardise the growth of its economic ties with East Asia. At the same time, however, Beijing finds itself caught on its own rhetoric, especially regarding its claim to the South China Sea as shown by the clash with the Philippines in the spring of 2012. Despite the diplomatic efforts seen earlier, this escalated rapidly with President Benigno Aquino calling on ASEAN countries to take a common stand against Beijing and warning that they should all fear 'what is transpiring' in terms of the PRC's maritime claims. This followed an editorial in *Global Times* which wrote of a potential 'small-scale war' to end the standoff, adding that 'Once the war erupts, China must take resolute action to deliver a clear message to the outside world it does not want a war, but definitely has no fear of it'.

The combination of continuing assertiveness and tactical diplomatic pull-backs is symptomatic of a foreign policy that is subject to different pressures and appears to lack overall direction. Some may minimise the examples given above as being simply regional matters that do not affect the wider global picture, but they suggest that – even in its own backyard – Beijing lacks strategic coherence. That may reassure states which would fear a determined, co-ordinated Chinese approach, but it also opens up the possibility of miscalculations and, by its nature, makes dealing with the PRC more difficult. Despite the many works celebrating Chinese statecraft handed down through the centuries, it is hardly a sign of maturity on the part of the revived superpower. ■

Access: China's Resource Foreign Policy

Shaun Breslin

China's search for resource security has come under close international scrutiny in recent years. This is partly because of the economic impact on other countries – most notably changes in the price and availability of some key resources. But there are also important political dimensions to these debates. For example, supporters of a liberal global order are concerned that China is undermining attempts to pressure authoritarian states to reform. If such states don't like the conditions that accompany aid and economic relations with the West (or more correctly, some in the West), then -if they have things that the Chinese want- they can deal with them instead. They might insist that you don't have political relations with Taiwan, and want guarantees that their investments are safe, but they won't pressure you to liberalise your political or economic systems. And as an added bonus, the repayment terms of Chinese development loans are often cheaper than those offered by places like the World Bank.

But at the same time, there is recognition in a number of developing countries that helping China meet its resource requirements is not always cost-free. Poor employment conditions in some Chinese-owned mines, the tendency to use Chinese workers rather than employ locals, the possibility of becoming dependent on Chinese demand, and the spectre of China buying up large tracts of land, have all generated complaints about Chinese activities in a number of states.

Moreover, there is a political dimension to debates over resource security in China itself. What looks like Chinese power and strength from the outside can look like potential weakness or vulnerability from the inside. With China unable to provide for its own requirements, what would happen to the Chinese economy if obstacles were put in the way of it accessing the resources China (or perhaps more correctly, China's leaders) want and need? So if you scratch the surface of debates over China's resource needs, you find that they are heavily informed by broader and pre-existing security concerns; either international concerns about China's rise, or concerns within China about possible limitations to that rise.

FROM SELF SUFFICIENCY TO GLOBAL ACTOR

Interest in China's global reach in resource sectors is not just a consequence of the extent of this reach, but also the speed at which it has occurred. Although heavily dependent on supplies from the Soviet Union in the initial years of the PRC, for the best part of thirty years China was largely self-sufficient. Indeed, as China emerged from international isolation in the 1970s, it was through exports of energy resources that China slowly rejoined the global economy (in a still rather limited way) and earned foreign currency to meet other developmental goals. It was not until 1993 that China became a net oil importer, and not really since later in the 1990s that Chinese demand began to exert a significant impact on global resource markets.

Part of this emergence as a global player was a result of the way in which China embraced the globalisation of production. As it became the workshop of the world, running large trade surpluses with major markets in the West, China actually ran large deficits with suppliers of resources used to manufacture its exports. So in some respects, while we think of 'China' as demanding and needing resources, this demand is in part at least predicated on the demand of consumers in the West (and elsewhere) for Chinese exports, and derives in part from the decisions of major companies to move their productive capacity to China from elsewhere.

But this demand is also a result of the changing structure of the domestic Chinese economy – of the expansion of industrial production (for domestic as well as international consumption), of massive urbanisation (and the immense transformation of existing urban centres), and infrastructure development that has occurred at times at a bewildering speed. Societal changes have not just increased consumer demand, but also changed it. Indeed, whole new markets and sectors have emerged, such as the private automobile market which was all but non-existent before the turn of the millennium. It's also not unfair to point to inefficient use of resources as being a factor in the increase of imports in some sectors.

Arguably the highest profile and perhaps most significant changes have been felt in global oil markets. This is partly because increased demand from China (and other emerging markets) has resulted in increasing prices for everybody. Those who are sceptical about China's long-term ambitions also point to the way China is investing in and buying up long-term supplies in many places, challenging the assumptions and interests of existing actors about the future. Furthermore, the places that China has turned to in its search for supplies has raised some eyebrows – countries like Sudan, Iran and Venezuela that have not always been seen as forces (or sources) of peace and stability in the liberal global order.

Yet China's resource demand goes much further than just energy. Up until fairly recently, the focus has primarily been on industrial resource sectors – in addition to energy resources, metals, minerals, rubbers, chemical products and so on. But as the urban population has grown and consumer tastes have changed, China has been unable to maintain its goal of being self sufficient in food resources. Soybean imports have increased rapidly, and have become a major component of China's economic links with Latin America in particular, as well as the United States. Grain imports that are directly eaten (rice and wheat) have also increased, but as Chinese consumers have begun to demand more meat products, imports of grain to feed livestock have increased even more rapidly. Imports of sugar have also rocketed to meet the Chinese consumers' collective sweeter tooth.

GLOBAL ECONOMIC CONSEQUENCES

As already noted, the most striking consequence of the growth of Chinese demand has been in the price of global resources. Popular attention has tended to focus on price rises – and for good reasons (as will be discussed shortly). But prices can go down as well as up, and for some resources like iron ore (for which China is the world's biggest importer) a dip in Chinese demand can have rapid negative impacts not just on producers, but also the major shipping companies that transport resources to China. In other sectors, access to resources (or the lack of it) is equally important as pricing; particularly during periods when China decides to increase its stockpiles of strategic reserves (for example, of copper). Rare earth metals used in electronic industries are a particularly important and rather unique case. Here, China has a near global monopoly on the mining and production of neodymium and dysprosium. By restricting exports in an attempt to lure high quality (and high value added) industries, Chinese government policy has had an impact on the global supply of resources used in the production of a range of commodities from mobile phones and televisions to car batteries and glass products.

While these issues point to problems, the increase in Chinese demand has been a positive force for many. In a number of African states, trade relationships with China have been the catalyst for rapid economic growth over the last decade. As well as either directly buying locally produced resources, and/or investing in and buying mines, oilfields and land, China has also become a major source of development aid for many African states. This includes loans that help develop national infrastructures (some of which of course enables the efficient export of goods and resources), and loans from the China Development Bank that typically entail partial repayment through resources. As China tried to spend its way through the global economic crisis in 2009, increased demand for resources helped a number of Latin American countries offset the downturn in demand from the USA and Europe and rebound relatively quickly.

And it's not just developing states that have benefitted from Chinese growth. Australian mining sectors have boomed on the back of increased Chinese demand, while China has now become the biggest export market for agricultural produce from the USA. If people, companies and countries are competing with China, producing the same goods and looking for the same resources, then China is often seen as a problem. But if you can supply what China wants and needs, then it's a rather different story.

THE INTERNATIONAL POLITICAL DIMENSION

The West and China's Resource (in)Security

The emergence of any new actor as large as China in global resource markets might be a cause of apprehension and concern. But it's notable that there doesn't seem to be the same level of concern about the growth and rise of India as there is about China. Indeed, the focus on what China is doing often ignores the fact that others are doing it too. It is true that Chinese oil imports have increased, but they are still dwarfed by imports by the United States; the US and the EU remain major investors in Africa; Japan has been a more than willing recipient of Sudanese oil; and South Korea and a number of Gulf States have been actively seeking opportunities to buy land in Africa to guarantee long-term food supplies. Yet the focus is often on China's impact on global prices, on China's economic impact on Africa, on China's irresponsible behaviour during the Darfur crisis, and on Chinese land grabbing.

Perhaps this focus on China in part emerges from a feeling that Chinese actors aren't playing fairly and that China is not conforming to the interests of major Western powers. For example, by talking to and trading with people that are shunned by the West, China is able to take economic advantage of their political isolation. At the same time, by providing an alternative to dealing and trading with Western states and/or the international financial institutions, China is seen to weaken attempts to pressure more authoritarian states to liberalise and reform, and to accept liberal political and economic norms. This is reinforced by China's declared opposition to intervening in the domestic politics of sovereign nation states, and a willingness to oppose proposed interventions at the United Nations. Thus, for example, China's resource requirements are seen as being one reason behind the longevity of the Chavez regime in Venezuela, and a key obstacle to pressuring Iran to change its nuclear policy.

There also seems to be considerable fundamental distrust of China's long-term objectives, based on an apparent assumption that if China gains control of resources then they will be transferred back to China for China's sole use, rather than being sold on into global markets for anybody to buy. The idea, then, is that there is a grand strategy orchestrated by the Chinese state and enacted by giant State Owned Enterprises (SOEs) to corner markets and create monopolies that will be to the detriment of other global actors, and possibly even to the global economy as a whole. So while selling things to China (and buying cheap goods from China) might make sense, allowing China to buy and control long-term supplies of resources is an entirely different matter.

China's leaders sometimes feed this suspicion by using major international events to articulate their goals and objectives in ways that make it look very much as if China has a grand strategy. When it comes to dealing with other developing states, there is also a clear attempt to show China as being very different from other previous great powers – powers that were perceived as arrogant and bullying, and who established unequal economic relationships to benefit themselves at the expense of the colonised developing state. While the primary target of these messages is the developing states themselves – to reinforce the idea that China will treat them with respect while seeking mutual 'win-win' benefits – its perhaps not surprising that the message is not always welcomed in the developed economies that are being criticised. The size and power of China's SOEs also reinforces this concern. In the wake of the global financial crisis, it seems as if China is one of the few countries that has the financial resources available to turn goals and aspirations into realities through state-sponsored investment and loan activities overseas.

While the search for long-term supplies is real and forms part of an overarching strategy, we need to take care not to see everything as part of an orchestrated state plan. The Chinese state has a strategy and objectives, but so too do Chinese companies. Often their objective is simply to make money – and this includes making money by selling what they produce and/or own to others rather than just shipping it back to China. It is also increasingly common to find Chinese SOEs competing with each other for projects, rather than working together to attain common and shared state goals. Rather than Chinese aid and loan programmes representing a coherent state strategy, they are often initiated by Chinese companies who want to use development finance as a means of expanding their operations (and their profits) within developing countries. And although SOEs remain dominant in large scale projects, smaller local government-owned and private companies are playing an important and increasingly independent role in China's overseas activities.

The 'South' and China's Resource (in)Security

China's search for resources has unsurprisingly been met with somewhat less scepticism in most developing states. China is not only an important new market for them, but is also a country that attaches very few political conditions to economic relations. Not recognising Taiwan as an independent political entity is a bottom line (and countries that are prepared to switch economic recognition from Taiwan to the PRC are well rewarded), and not welcoming the Dalai Lama is appreciated. Whilst not a formal condition, supporting China's position when it comes to votes on its human rights record is also valued. But China is not going to insist on good governance political reforms, or extensive economic liberalisation and privatisation, before extending development loans or signing commercial contracts. For leaders in some developing states, China's example of how to promote rapid economic development without simultaneously democratising and diluting the power of state elites has also become a rather attractive 'model'.

This said, China's resource engagement of other developing states is not an unquestioned good news story. That Chinese equipment and workers are often used in Chinese projects has led to complaints about the shallow nature of Chinese engagement – countries and companies make money from China, but the broader population does not gain much. Conversely, in some cases where large numbers of locals have been employed – for example, in copper mines in Zambia – there have been complaints about low pay, poor (and illegal) work conditions and a lack of interest from Chinese managers when complaints are made. There has also been hostility towards the Zambian government for not insisting that the law is adhered to. Even when Chinese managers shot striking workers prosecutions conspicuously failed to follow, with the fact that copper mining is the major source of exports and government income in Zambia thought to be no mere coincidence.

Zambia is perhaps the most extreme case – or at least the place where complaints and concerns about Chinese economic activities and influence over domestic politics have been clearest and loudest – but similar issues have also been raised in other African states. In Latin America, the focus seems to be more on the danger of switching previous dependence on the United States and the West for a new dependence on China. This is particularly the case where one or two commodities dominate resource exports to China and there is very little diversity in the export basket.

This concern also seems to be inspired by changes in how China wants to source its resource requirements from the region. Rather than just buying soybeans, for example, Chinese companies have been increasingly seeking to buy land to produce the soybeans on themselves. As already noted, China is far from the only country actively seeking land overseas to provide for its food security in the long-term. But whomever the potential buyer, selling land seems to generate different sentiments and concerns compared to selling resources – and not just in Latin America.

CHINA'S RESOURCE (IN)SECURITY

One of the reasons that China has been looking to Latin America for soybean supplies is an attempt to diversify its imports away from the United States, in the context of Chinese fears about potential dependence on an unreliable if not downright hostile economic partner. Indeed, if we go back to the mid-1990s when China was first beginning to emerge as a global resource actor, concerns about the nature of the global balance of power was already playing a role in shaping Chinese policy. At that time, there were a number of events that seemed to indicate a concerted attempt to demonise China and prevent it from retaining its 'rightful' place in the world. This included linking China's attempts to join the World Trade Organisation (WTO) to human rights issues, and the only very narrow failure of a vote to condemn China at the United Nations Commission on Human Rights in 1995. It also included the failure of Beijing to win the Olympic Games in the 1993 vote, an outcome that was widely interpreted in China at the time as a clear and deliberate case of political interference by the West.

So China re-emerged on the global economic stage with many Chinese convinced that some in the West were deliberately creating a 'China Threat thesis' to create unease over Chinese objectives and goals. As the need for imported resources increased (as well as the need to maintain access to markets to facilitate export led growth), then a new interest in economic and resource security began to emerge, with a heavy emphasis on perceived insecurity and potential vulnerability. This insecurity was only exacerbated when the 1997 Asian financial crisis briefly threatened to derail China's growth momentum. China's resulting resource diplomacy has subsequently reflected a perceived need to reassure others that China will not disrupt the global order, but is instead a force for peace, stability and common wealth. As imported resources – first energy, then other raw materials and more recently, food – became increasingly important in attaining domestic development goals, then maintaining a stable international environment in which China could get what it needed became ever more important.

Because part of this message entails establishing that China won't repeat the mistakes and crimes of previous great powers as they expanded their global reach, claims to responsibility that have not always been believed, particularly in the West. And yet the record shows that while China might not always be very quick in responding to international pressure to weaken its links with supposed 'rogue states', China's leaders have responded to negative judgements and shifted their policies. And it clearly irks people in China (and not just the Chinese leadership) that Chinese resource companies continue to be prevented from successfully bidding for commercial deals because they supposedly represent security challenges to the United States and others.

There is also something of a tension between the desire to show Chinese responsibility on one hand, and the importance of reinforcing China's rightful core interests on the other. These core interests include defending China's sovereign territorial integrity, but a key problem here is that the maritime limits of this sovereign territory are not accepted by many of China's regional neighbours, who have conflicting claims. Who owns (or perhaps more correctly, controls) these waters has important implications for resource politics – not just in terms of potential underwater energy supplies but also in terms of controlling key sea-lanes of communication. The rather strident assertion of Chinese territorial claims in recent years thus reveals the Janus-faced way in which the state is promoting China's national identity in search of long-term security. On the one hand, there is the image of a responsible and peaceful China, and on the other, a China that is committed to doing whatever it takes to secure what it believes to be its rightful possessions. These tensions in Chinese policies are partly a reflection of the increased complexity of Chinese politics, with different actors promoting different identities and preferred policies. But the result is that it allows external observers to emphasise the image and idea of China that gives credence to their pre-existing opinions.

CONCLUSION

Concern about resource insecurity has resulted in the establishment of new priorities and objectives for China's international economic interactions, focusing on the search for secure and reliable sources for the long-term. But the existence of an overarching goal does not mean that the state is in control of everything that happens in the supposed name of China. With even large SOEs typically operating with considerable operational autonomy overseas, it becomes very difficult for the state to establish and maintain a preferred identity as a specific type of international actor. As more and more Chinese actors get involved in resource industries on the ground in different countries, this task is likely to get even harder.

Moreover, as China increases its global reach, not least because of the need to secure sustainable supplies of resources for the future, it is increasingly being drawn into debates and conflicts that its leaders would presumably prefer to avoid. China's economic contacts with Sudan, Libya and Iran are three good examples. In the process, maintaining a strict and uncompromising non-interventionist policy appears to be becoming progressively more difficult to maintain.

In combination, these two issues suggest that China is increasingly facing the sort of conflicting pressures, logics and demands that are part and parcel of being a major global economic actor. Perhaps we could even suggest that China is looking more and more like a 'normal' economic power. But this normality is qualified in two ways. First, there is a considerable section of the international community that remains unconvinced – and perhaps can simply never be convinced – about this normality, and continue to see China as an revisionist and predatory state. Second, there is a strand of Chinese rhetoric and policy pertaining to issues of sovereignty that does much to worry people (primarily, but not only, in China's own backyard) about China's long-term pacific intentions.

Increasing domestic industrial efficiency and the further expansion of new sources of energy might alleviate some of the need to look overseas for ever more resources. But it is not going to make the issue go away, and in addition to the search for industrial supplies, it seems likely that the search for food security is going to become ever more urgent in coming years. As this could place still greater focus on the ownership of land, then China's international resource politics might become an even more sensitive issue in a number of countries in the future. Maintaining and promoting the idea of Chinese responsibility could thus become an increasingly important task – but at the same time, an increasingly problematic one. ■

China as a Trading Superpower

Xiaojun Li

Just over three decades ago, when Deng Xiaoping announced the policy of reform and opening-up in 1978, China's total imports and exports of $20.6 billion ranked 32nd among all nations and accounted for less than one percent of global trade. In 2010, China's total merchandise trade exceeded $3 trillion, 143 times the level of 1978. With an annual growth of 17.2 percent in exports and 16.4 percent in imports, China now account for 10.4 percent and 9.1 percent of global exports and imports, making it the world's largest commodity exporter and second largest commodity importer.[1]

China's meteoric rise to trading superpower status have raised concerns from foreign policymakers as they evaluate how China's increased economic clout will affect their economies and the global trade regime as a whole. In this context, this article assesses China's evolving trade policies in the reform era, the sustainability of its export-led growth amidst the global economic downturn, and the implications for global trading governance.

CHINA'S RISE TO TRADING SUPERPOWER

Under the centrally planned economy prior to 1978, China conducted minimal trade with the rest of the world, exporting just enough raw materials and simple manufactured goods to cover payments for imports of strategic minerals and other production materials not available at home. This inward-looking, planned economic development strategy was reversed with the policy of reform and opening-up beginning at the end of 1978, which committed China to widen its foreign economic relations with the outside world. The reform period witnessed a series of structural and economic policy changes that reorganised and decentralised foreign trade institutions, promoted foreign economic relations and foreign direct investment, expanded foreign trade, and ushered China into a number of international organisations.

Through most of the 1980s, both imports and exports rose steadily, albeit unevenly, under an import substitution strategy aimed at promoting local production of industrialised products. Exports grew faster than imports from 1980 to 1983, leading to trade surpluses in those years. Over the next six years, however, imports surged due to the expansion of foreign reserves, the decentralised management of foreign trade and large purchases of foreign plant and equipment for domestic industries. In order to reduce the resulting trade deficits, a series of policies were introduced, including an import and export licensing system, stricter controls on foreign exchange expenditures, and the gradual devaluation of the renminbi by over 60 percent over the decade (see Figure 1). Overall, foreign trade reforms in the 1980s focused on transforming China's highly centralised system to incorporate elements of a market-based economy. The gradual liberalisation of trade resulted in incredible growth of the economy in terms of GDP, trade and foreign investment. By the end of the 1980s, Chinese trade totalled $115.4 billion, representing 24 percent of China's GDP and 3 percent of total world trade and catapulting China to the 16th largest trader in the world.

1 Note: Data used in this article are drawn from the following sources: China General Administration of Customs, the Chinese Ministry of Commerce, China Statistical Yearbook, the International Monetary Fund, the World Bank World Development Indicators and the World Trade Organisation.

With major reforms in taxation, banking, exchange rates and foreign exchange management that took place in the 1990s, China's trade volume continued to grow as Beijing gradually moved toward an export-led development strategy. Two aspects that contributed significantly to the expansion in exports and imports during this period are worth highlighting. First, China abolished the dual-track exchange rate system in 1994 and created a unified rate pegged to the US dollar, depreciating the renminbi by 44 percent from the previous year (see Figure 1). The renminbi exchange rate remained stable for the next 11 years, granting a competitive edge to China's already cheap exports and, at the same time, fuelling foreign criticism of currency manipulation. Second, to pave way for China's bid to join the World Trade Organisation (WTO), Beijing engaged in a series of voluntary tariff cuts on over 5,000 products, driving down the simple average of tariffs from 47.2 percent in 1990 to 15.8 percent in 1999 (see Figure 2).

Figure 1: China's Trade and Exchange Rate, 1978-2010

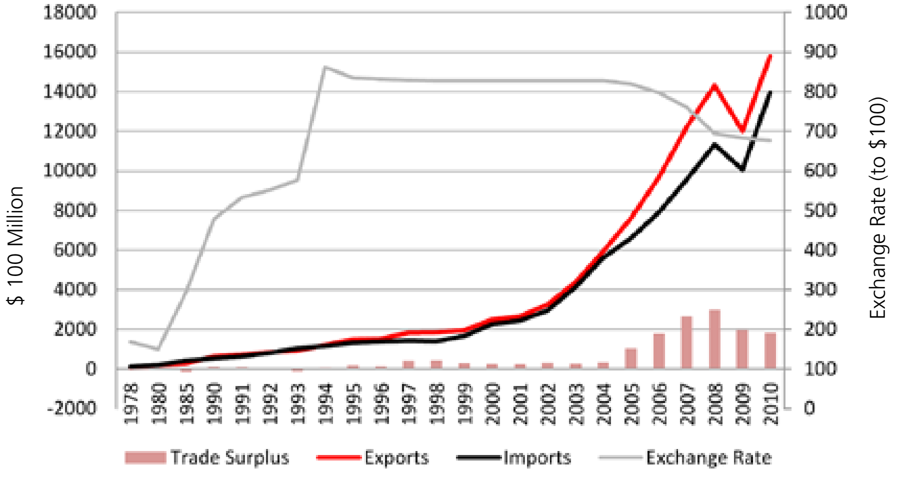
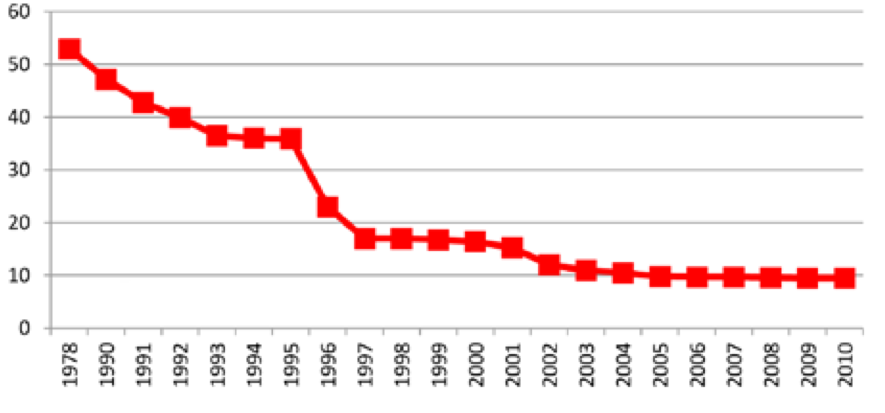


Figure 2: China's Average Tariff Rate, 1978-2010



Thus, despite government intervention to cool down the economy in the mid-1990s and the Asian Financial Crisis of 1997, Chinese imports and exports achieved remarkable annual growth rates of 14 percent and 16 percent, respectively, and reached $474.3 billion in 2000, putting China sixth in the global trade ranking.

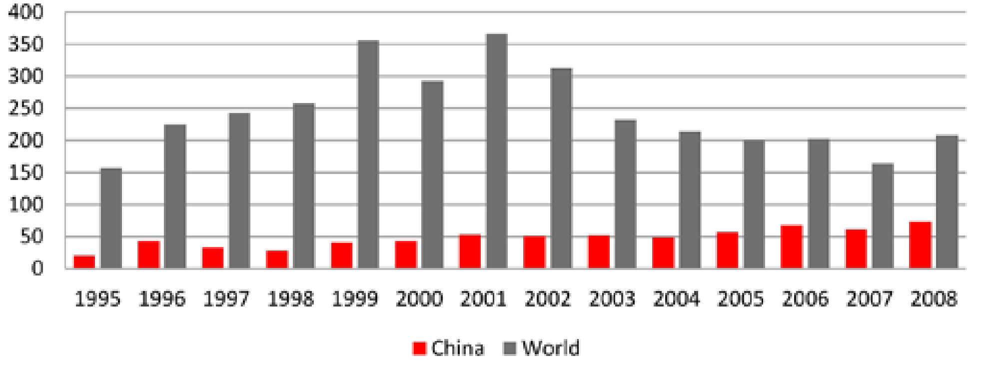
On November 11, 2001, China formally joined the WTO as the 143rd member of the multilateral economic institution that governs over 90 percent of global trade. In its accession package, China promised to offer WTO members greater market access to its agriculture, manufacture and service sectors by lowering tariff barriers, removing nontariff measures and bringing its domestic laws, regulations and other trade-related measures into conformity with WTO rules. WTO membership enabled China to become fully integrated into the global market and unleashed its potential as a trading power. Consequently, between 2001 and 2008, China's trade grew exponentially (see Figure 1) with imports and exports both crossing the $1 trillion mark in 2008.

CHALLENGES TO CHINA'S TRADE-LED GROWTH

The speed of China's rise to trading superpower status has been nothing short of phenomenal. Foreign trade has become China's main engine of economic growth, contributing to over 50 percent of China's GDP since 2002. Notwithstanding these remarkable achievements, there remain a number of important social and economic challenges, including various economic imbalances that stem from the rapid trade-led growth, which could jeopardise the stability of the economy and thus the achievement of the Communist Party's ultimate goal of 'harmonious society'.

First, throughout the reform period, China's exports have grown at a much faster rate than its imports, contributing to ever-widening trade surpluses that peaked at $298 billion in 2008 (see Figure 1). This has prompted Western countries to accuse China of currency manipulation since it joined the WTO. The United States, in particular, charged that the renminbi was significantly undervalued by as much as 40 percent, making Chinese exports to the United States cheaper than they would be if exchange rates were determined by market forces. Although in July 2005 the renminbi was revalued by 2.1 percent in relation to the US dollar – allegedly as a result of increased international pressures – and the value of the renminbi has increased by 30 percent since China moved to a managed floating exchange rate regime with respect to a basket of currencies, the trade surpluses continued to rise, leading to the passage of two currency bills at the US Congress and Senate in 2010 and 2011. Heavy dependence on manufactured exports has also left China vulnerable to import

Figure 3: Antidumping and Countervailing Investigations Against China, 1995-2008



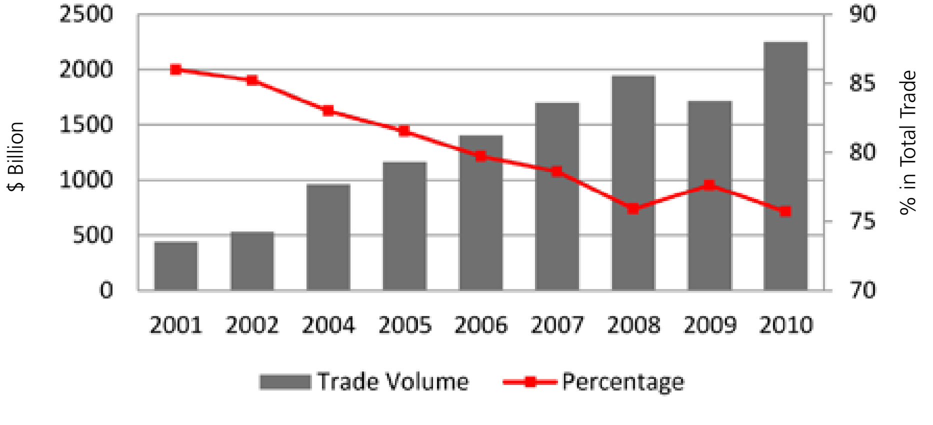
restrictive measures from its trading partners. Since 1995, for example, China has consistently ranked as the country that is subjected to the highest number of anti-dumping and countervailing measures. According to the statistics released by the WTO, 35 percent of all anti-dumping investigations and 71 percent of all countervailing investigations since 2008 have been targeted at Chinese products (see Figure 3).

Second, China's trade has long been structurally unbalanced, with overreliance on exports from traditional low skilled, low technology, and resource and labour-intensive industries. These industries are beginning to lose their external competitiveness as labour force growth slows and labour costs rise, and because of bottlenecks in land, water, and energy resources exacerbated by over-extraction and duplicate investments. In addition, until 2008 the majority of China's exports were from trade processing industries with low value added. For instance, China earns only two percent of the total value for each iPad it assembles and exports to the rest of the world. Such structural imbalances cast doubt on the long-term sustainability of growth in trade and the economy.

Third, China's trade is conducted disproportionally with a small group of countries (see Figure 4). In 2001, China's ten largest trading partners – Japan, the United States, the European Union, Hong Kong Special, the ASEAN countries, South Korea, Taiwan, Australia, Russia and Canada – accounted for 87.3 percent of exports and 84.5 percent of imports. These numbers dropped to 80.7 percent and 72.3 percent by 2008, but were still much higher compared to the United States (61.4 percent and 65.9 percent). Such heavy trade dependence exposes China to much greater risks during economic slowdowns resulting from systemic and structural shocks in the global economy, such as the most recent financial crisis in 2008.

Finally, the pace of China's growth has exacerbated a number of domestic social and economic problems. Income inequality has widened, especially between urban and rural residents and between the coastal and inland regions. The GINI index, measures inequalities within a population, has risen from 0.28 at the beginning of the reform period to 0.52 in 2010, making China the fourth most unequal country in the world. China has also paid a high environmental premium for its growth, which has been fuelled by unsustainable, energy-inefficient industries, leading to severe and widespread environmental problems. According to a World Bank report in 2007, 16 of the 20 most polluted cities in the world are Chinese. If left unattended, these problems may seriously hamper China's long-term development goals and its effort to maintain social and economic stability.

Figure 4: China's Trade with its Top 10 Trading Partners, 2001-2010



RESPONSES TO THE GLOBAL FINANCIAL CRISIS

The global economic recession that began in late 2008 posed the most serious challenge to China's dependence on export-led growth. In 2009, China's exports fell by 16 percent and imports fell by 11 percent due to sluggish demand both at home and abroad. Real GDP growth declined from 9.6 percent in 2008 to a year-on-year rate of 6.2 percent in the first quarter of 2009, the lowest rate in more than a decade. Meanwhile, Chinese exports also became the major target of worldwide protectionist measures. According to one study, of the 2,197 import-distorting measures such as state bailouts, local content requirement and subsidies taken by countries during the current global downturn since March 2009, 1,053 – or 49 percent – directly or indirectly affected exports from China.

At the same time, however, the crisis also provided China with the opportunity and reinforced its intention to tackle many of the challenges described in the previous section by introducing a series of structural reforms aimed at diversifying its economic structure, making the labour market more flexible, strengthening social safety nets, promoting greater private sector participation and competition in the economy, and developing a more efficient capital market.

The centrepiece of China's response to the global financial crisis was its four-trillion renminbi ($570 billion) stimulus package unveiled at the end of 2008. The stimulus financed programmes in areas such as low-income housing, rural infrastructure, water, electricity, transportation, the environment, technological innovation and disaster rebuilding, among others. Its goal was to offset slowing exports and investment amidst global economic conditions by raising domestic consumption, a shift long advocated by analysts of the Chinese economy and by some within the government. In addition to boosting consumption, the stimulus package was also designed to address the various structural imbalances in the economy. For instance, priority was placed on investments and projects in clean technology and indigenous innovation. Social services such as health and education were expanded to improve human capital and facilitate the movement of surplus labour from low-productivity sectors into other activities, notably services.

Simultaneously, China sought to further expand its trade with developing and emerging markets. Since becoming a member of the WTO in 2001, China has been actively exploring trade opportunities in these markets through bilateral and free trade agreements (FTAs), signing the Framework Agreement on China-Association of Southeast Asian Nations (ASEAN) Comprehensive Economic Cooperation in as early as November 2002. Since then, China has signed nine additional FTAs and Economic Partnership Arrangements (EPAs) with Singapore, Pakistan, New Zealand, Chile, Peru, Costa Rica, Hong Kong, Macao and, most recently, Taiwan. In addition, FTAs between China and the Gulf Cooperation Council, Australia, Norway, Iceland and the Southern African Customs Union are being negotiated while joint feasibility studies on regional trade arrangements with India, South Korea, Japan and Switzerland have been completed (see Table 1). Overall, China's existing and proposed FTAs cover 28 economies in five continents.

Trading with emerging markets and FTA members allowed China to recoup some of the losses in exports that resulted from depressed demand in developed markets such as the European Union and the United States. In the first quarter of 2009, for instance, China's exports to Pakistan grew by 32 percent in the context of a 12 percent drop in that country's total imports. In the same year, China also became Brazil's largest trading partner.

With the help of the stimulus package and trade diversification, China was one of the first countries to recover from the global economic recession, achieving year-on-year GDP growth of 8.7 percent in 2009, surpassing the level predicted by most analysts a year earlier. China's trade also rebounded in 2010 (see figure 1), with trade volumes with the emerging markets growing at a much faster rate than with its traditional markets: China's trade with the ASEAN countries, Brazil, Russia, South Africa, and India during the year increased by 37.5 percent, 47.5 percent, 43.1 percent, 59.5 percent and 42.4 percent, respectively, while the numbers for traditional trading partners such as Japan, the European Union and the United States hovered around 30 percent.

Table 1: China's Free Trade Agreements

FTAs and EPAs in Force	First Agreement Signed
China-ASEAN FTA	November 4, 2002
China-Pakistan FTA	November 24, 2006
China-Chile FTA	November 18, 2005
China-New Zealand FTA	April 7, 2008
China-Singapore FTA	October 23, 2008
China-Peru FTA	April 28, 2009
China-Costa Rica FTA	April 8, 2010
Mainland and Hong Kong Closer EPA	June 29, 2003
Mainland and Macau Closer EPA	October 18, 2003
Mainland and Taiwan Economic Cooperation Framework Agreement (ECFA)	June 29, 2010

FTAs under Negotiation	Latest Round of Negotiation
China-GCC(Gulf Cooperation Council) FTA	June 22, 2009
China-Australia FTA	February 28, 2010
China-Iceland FTA	May 5, 2008
China-Norway FTA	September 16, 2010
China-SACU(Southern African Customs Union) FTA	July 2, 2004

FTAs under Consideration
China-India Regional Trade Arrangement Joint Feasibility Study
China-Korea FTA Joint Feasibility Study
China-Japan-Korea Joint Study
China-Switzerland FTA Joint Study

MOVING FORWARD

As emphasised in Premier Wen's Government Work Report delivered at the annual session of the National People's Congress in 2012, while it is important to expand domestic demand, foreign trade has been a key driver of China's economy and will continue to be so for the years to come. The 12th Five-Year Plan (2011-2015) further stipulates that China should maintain an annual growth rate of 10 percent in trade and that total trade volume should reach $4.8 trillion in 2015. Given the pace of trade growth in the past three decades and the trend of the recent rebound, there is no reason to believe that the goals set in the five year plan cannot be achieved, or, more likely, exceeded. According to a recent report by Citigroup, China is expected to overtake the United States to become the world's largest trader by 2015 and remain in the top spot until at least 2050.

As its share in global trade continues to rise, China as a trading superpower is likely to encounter even more frictions with its trading partners, particularly for policies that have already been repeatedly criticised by foreign governments, such as currency devaluation, widespread violation of intellectual property rights, and a number of discriminatory measures in trade, innovation and investment. Recent cases of such policies include China's export restrictions on rare earths and its indigenous innovation product measures and the China Compulsory Certification (CCC) mark, which, according to the European Union's Ambassador to China, created significant obstacles to imports in China. These trade-distorting policies leave Chinese consumers worse off, stoke up protectionism abroad, and could potentially lead to a downward protectionist spiral and further weaken the global recovery.

Fortunately, while there is still a long way to go, things seem to be improving. On various occasions, Chinese leaders have expressed their willingness to address these issues and contribute to the stability of the global economy. In addition, China's recent experience with the WTO's Dispute Settlement Body (DSB) suggests that the country is gradually internalising the principles of fairness and non-discrimination embodied by the multilateral trading regime, committing to comply with all DSB rulings and redress its WTO-inconsistent policies in a number of cases. It is therefore critically important for the rest of the world to continue to engage China in the WTO and other regional and multilateral institutions, and refrain from unilateral measures such as the US currency bills which could backfire and trigger trade wars. The rise of China as a responsible trading superpower can not only strengthen China's economic relations with the world and the global trade regime as a whole, but, at the same time, help China accomplish its own domestic economic reform goals. ■

Firms with Chinese Characteristics: The Role of Companies in Chinese Foreign Policy

Jie (Cherry) Yu

In recent years, Western media and governments have portrayed Chinese companies as soldiers in an economic Trojan horse, quietly buying up the world in an attempt to challenge the prevailing order. Indeed, in 2006, the Chinese government had launched a national campaign to encourage Chinese firms to 'Go Global', part of a strategy to increase China's competitiveness and help rebalance China's export-oriented growth model, as well as gaining political capital overseas. Chinese companies have acquired natural resources and purchased sophisticated technologies from their business partners and competitors. Meanwhile, the scope of Chinese foreign policy has expanded enormously, with its economic aspects given equal weight to Beijing's security concerns. As a result, Chinese firms have become an indispensable part of China's foreign policy making process.

However, whilst Chinese companies are clearly one vehicle of China's great power ambitions, its firms' overseas activities deserve more nuanced analysis. Chinese firms play a crucial role in China's geo-economic strategy, but despite their sheer size, Chinese companies are short of global business exposure. Moreover, their very close relationship with the Chinese government has constrained their ability to become influential players in world economic affairs.

A TYPOLOGY OF CHINESE FIRMS

The Chinese firms analysed in this article are divided into three categories: the China International Investment Corps (CIC); the State Owned Enterprises (SOEs); and large privately-owned companies. The most distinctive characteristic of all three types of companies are their close associations with the Chinese government, either in terms of funding or in terms of the strategic direction of their business activities.

The China International Investment Corps

The China International Investment Corps is China's own sovereign wealth fund (SWF). The CIC was set up in 2007 by the Chinese government as an investment institution tasked with generating higher returns on China's $3,200 billion of foreign reserves than those offered by the US Treasury. The CIC's formidable size, with a $200 billion seed fund and later $400 billion under its management, has attracted unprecedented attention around the world, and helped stimulate debate about the international role of SWFs more generally.

The CIC has been particularly active in Europe and Africa, to the extent that it has become a representative of the Chinese government in conducting its economic statecraft. Around the world, SWFs are paying particular attentions to the type of industry they want to invest in, and measure their returns on investments over three to five years cycle. CIC has concentrated on industries such as civil aviation, civil nuclear technology, bio-tech, infrastructure and oil and gas. In financial year 2009-2010, the average Return on Investment (ROI) for CIC's portfolios was around 11 percent, with a focus on high-technology portfolios in Europe and energy portfolios in Africa. In 2011, CIC seized opportunities to invest in European infrastructure portfolios, mostly via the easier route of equity purchases rather than directly managing the targeted companies. This is because directly management requires related industrial expertise, which the CIC often lacks. Moreover, investing in infrastructure programmes provides local employment opportunities, which CIC hopes will help mollify any hostility to its investments within the countries involved, as for example in the case of CIC's 8.6 percent equity purchase of Thames Water in January 2012. CIC has been particularly active in the UK since its market is more open to foreign investment than comparable economies on the continent.

The CIC's activities in Europe are mostly based on commercial merit, and focused like any other private investors on profit maximisation and risk avoidance. However, its opaque management structure and its direct links with the State Council have caused great discomfort and at times outright hostility in hosting countries. The head of the CIC, Lou Jiwei, and most of its senior management, are directly appointed and assessed by the Chinese Communist Party's Department of Organisation, and its investments are the subject of significant public political scrutiny. For example, the CIC's very first investment, in Blackstone Corporation, a US private equity firm, made a huge paper loss and was much criticized domestically, resulting in the State Council ordering CIC to withdraw from the investment, turning a 'paper loss' into a 'real loss' of $1.9 billion. The head of the CIC was subsequently asked by the CCP Department of Organisation to explain the reasons for the loss during his annual performance assessment meeting. Thus the CIC's close ties with both the government and the Party have distorted its portfolio management and may undermine CIC's foundational goal of better utilising China's foreign reserves.

The State Owned Enterprises

The second category of the Chinese firms is the State Owned Enterprises (SOEs), which are mainly located in the energy, utilities, telecommunications, chemical, transportation and construction sectors. The firms constitute the main corporate tax-payers in China, and their activities and performance are supervised by the PRC State Owned Assets Supervision and Administration Commission (SASAC), which is currently responsible for 125 large SOEs. Like the CIC, the Chairmen of large SOEs are appointed and assessed by the CCP Department of Organisation. They are also party secretaries of their respective companies, and their overall management performance is evaluated by SASAC and Department of Organisation. Most subsidiaries of large SOEs are publicly listed, on either or both of the Hong Kong and Shanghai stock exchanges depending on different types of stocks. Unlike Western multinational companies, their non-state shareholders play little role in determining their corporate strategies and overseas investments plans. Instead, their party secretaries usually possess final decision-making power to initiate corporate strategies. Given their direct ties to the government, it is difficult to judge whether SOEs' overseas investments plans are political decisions or based purely on commercial merit. Their close links with the state has become a double-edged sword for Chinese SOEs, providing support for overseas expansion but also hindering growth and profit-making in foreign markets, where their direct links with Beijing have often provoked suspicions and hostility.

Large Privately Owned Companies

The final category of Chinese firms is the large privately owned companies. Many of these are the most well-known Chinese companies worldwide, including brands such as Huawei, Lenovo and Geely. Unlike the SOEs, they are private companies with powerful individual shareholders who decide corporate strategies. They are independently run but are supervised by Ministry of Commerce (MOFCOM), and despite their operational independence, some of their senior management previously served in governmental institutions or the PLA. Doubts about the authenticity of their independence was emphasised by the deep suspicions in Western media (and among their potential clients) that marked a series of large scale overseas acquisitions were advertised yet necessarily supported by Beijing, which were seen as successes of Chinese companies 'Going Global'. This has hindered their business operations overseas, especially in in OECD countries.

'GOING GLOBAL'

China's foreign economic policies have largely been directed to serve domestic economic and developmental interests. As Chinese growth has developed, those interests have become focused around the need for internal and external rebalancing of the economy. Over the past decade, the Chinese economy has been stimulated largely by ever-growing volumes of exports and major infrastructure investments. However, given the persistence of financial and sovereign debt crises, Beijing has acted on the realisation that relying upon the export of low value-added manufactured goods cannot ensure the sustainable growth of the Chinese economy. Similarly, simply building more infrastructure is likely to aggravate overcapacity in the absence of significant sectoral reform. The Chinese economy therefore requires restructuring both in an immediate timeframe and over the longer term.

At the immediate level, foreign consumer demand for manufactured goods has fallen drastically in the aftermath of the 2008 financial crisis, whereas labour and raw materials costs have risen disproportionally high, allowing lower-wage countries such as Vietnam and Cambodia to present substantial challenges to Chinese manufacturing. Over the longer term, expanding production scales and volumes are no longer sufficient to fuel growth. Instead, Chinese firms need to move up the value chain of the global manufacturing sector. Currently, for a typical manufactured product, less than 20 percent of the first profit margin is captured by its Chinese manufacturer, with the remained shared by the product designers and downstream distribution, marketing and end-customer support. 'Going global' aims to equip Chinese firms to compete with foreign competitors for this remaining 80 percent. The short-cut employed has been to utilise China's large amount of foreign reserves and companies' cash to acquire financially distressed companies in developed countries, which are already equipped with the industrial and commercial brilliance that requires to make breakthrough.

Alongside this economic adventurism in the developed world, soaring energy demand has led Chinese firms to explore opportunities in resource-rich but politically unstable areas, particularly for new sources of oil and gas, as documented elsewhere in this report.

A further rationale behind the strategy of 'going global' is to ease political pressure on renminbi exchange rates with the rest of the world. Currently, foreign currency earned by Chinese exporters must be exchanged for renminbi once it arrives back on China's shores. This fixed mechanism requires that the People's Bank of China (PBOC) holds an enormous amount of foreign reserves in order to manage renminbi transactions, and keep exchange rates at a level that provides a hedge against the volatility of global currency markets. Reducing China's reliance on exports and investing abroad will alleviate the political pressure on Beijing when it crafts its foreign policies. The more foreign companies the Chinese acquired, the closer economic links with investment destinations will induce. This in turn will reduce the economic and political pressure to allow renminbi to rise. As a result, the renminbi exchange rates will be less likely to be a priority of China's relations with other economies.

Indeed, Chinese firms 'Going Global' may be considered a better alternative than holding governmental bonds. This has been particularly the case during the eurozone crisis. China faces a dilemma of whether to follow its economic interests as the EU's largest trading partner and increase its holdings of euro-denominated bonds, with the consequent risks that increasing its holdings will only further trap Beijing in this troublesome monetary union. On the other hand, reducing

Chinese exposure by reducing its holdings will certainly alienate political allies and more importantly threaten vital sources of imports of advanced technologies. The alternative is to encourage companies investing in the EU, particularly in areas such as aviation and civil nuclear sectors which would not have been open to foreign investors before the crisis.

For Chinese firms, 'Going Global' will ultimately increase their exposure to mature market economies, allowing them to learn sophisticated management skills and to create long-lasting brand value for their products. These intangible assets are abundant in developed countries but relatively scarce in China, and their development by Chinese firms will boost sales volumes and profits. Moreover, those companies that invest themselves of the opportunities of global expansion will reap the benefits in competitive advantage over other Chinese firms both in the domestic market and abroad.

THE LIMITS OF 'GOING GLOBAL'

Chinese firms are determined to become some of the most important players in world economic affairs. However, their close association and somewhat submissive relationship with the Chinese government have impeded their overseas business plans. Moreover, Chinese firms often lack the requisite management skills to operate successfully in their investment destinations.

The policy of Chinese firms 'Going Global' has been eagerly supported by national and local governments, as well as by policy banks, such as China National Development Bank and China Exim Bank. However, their close links with the government posed fundamental challenges to their overseas investments plans and existing business operations. All three types of Chinese firms need to gain approval from corresponding governmental institutions in order to carry out investment plans. Official documents from the PRC Ministry of Commerce (MOFCOM) require that 'all outbound investment plans must be submitted to MOFCOM for approval', centrally if the investment volume exceeds $100 billion, and at the provincial level for smaller investments. In addition to MOFCOM's approval, investors must consider the interests of other governmental departments, such as the National Development and Reform Commission (NDRC), SASAC, PBOC and China's Banking Regulation Commission. Even if a project is approved, the involvement of various government bodies with divergent attitudes towards overseas projects can cause delays, and any of the key governmental bodies I mentioned above can veto particular projects that they regard as unviable or which pose threats to their departmental interests.

The intricacies of the approval process are not the only domestic constraint Chinese firms have faced. There is considerable evidence that Chinese firms have on occasion made clearly loss-making investments at the behest of government, which uses the deals as instruments to develop Beijing's bilateral relations with other countries. Moreover, the government does not take responsibility for firms' financial losses that result from signing such investment deals.

Alongside the hurdles of initiating overseas investments, Chinese firms have also encountered difficulties when high profile investments run into trouble abroad, with firms suffering losses provoking a strong sense of public anger and nationalistic sentiment. SOEs that have failed to acquire foreign companies or made significant financial losses are treated as traitors, and their management have occasionally been forced to apologise to both the public and Party elites. For example, CNOOC's high profile, failed bid for Unocal, the seventh largest American oil and gas company, led to the company's CEO cutting his annual salary and submitting a letter of self-criticism to the Department of Organisation and SASAC to apologise for his 'mistake' and explain why he failed in the bid. Such interplay between high-level politics and overseas investment decision-making has done more harm than good for Chinese firms' global expansion plans.

Yet despite the political difficulties that Chinese firms face, the biggest obstacle to their 'Going Global' is that they are not equipped with the sufficient management skills to take on complex and long-term investments abroad. Many Chinese firms have enough cash to acquire foreign companies, but have lacked the confidence and knowhow to deal with the challenges involved. Such hurdles co-exist on both the production side of their operations and downstream distribution channels. Most of the senior management teams of large Chinese SOEs appointed by the Party are equipped with industrial expertise, but not the necessary management skills and general market knowledge. These SOEs are unfamiliar with the market environments of investing destinations and have little understanding of their end-customers in foreign countries. As a result, they hire leading global consulting firms and investment banks to develop their overseas expansion plans. Some Chinese companies believe that outsourcing professional services firms is equivalent to possessing sound overseas project-management skills themselves. However, the strategies offered by management consultants need to be tailored to the Chinese firms' own requirements, yet are often based on the assumption that these companies have established and transparent corporate governance frameworks. Chinese companies may also hire professional services firms on the basis of their reputations rather than their deep industrial knowhow. In part, this reflects the fact that engaging such major multinationals shows that Chinese firms can afford to employ consultants and investment bankers for their overseas projects, and in so doing validates their balance sheets.

On the production side, some Chinese firms, in particular SOEs, are unaccustomed to operating in a mature market economy. Over the past decades, Chinese firms have operated a model based on large-scale investments, an uncompetitive domestic market and low returns on investment (ROI). Their profits have at least in part been derived through government interventions and protection. Chinese firms that operate abroad do not have 'the Umbrella' of the state, often operating in mature market economies where government interventions are minimal. Firms sometimes naively assume that smooth bilateral political relations between China and their investing destination countries will automatically produce good business environments, and believe they can therefore conduct 'business as usual' in those countries as they would in China.

This of course is far from the reality. Most Chinese firms have had difficulties dealing with local labour unions in their investment destinations and with respect to the cultural differences of local employees. Independent organised labour is a relatively new concept in China. China's All Labour Union is affiliated to the CCP, whereas unions in OECD countries are often formidable forces in salary and welfare negotiations with their employers. Chinese companies have believed that simply retaining local labour forces following an acquisition will be sufficient to maintain good industrial relations, and are not accustomed to labour unions asking for salary increases or going on strike. Chinese firms' lack of experience in negotiating with unions has had detrimental effects on their overall operations abroad. For example, Shanghai Automotives (SAIC) managers began cutting hundreds of Ssangyong workers in 2006, and their relations spiralled downward. Ssangyong employees went on strike for nearly two months. Workers barricaded themselves inside the factory and locked the managers out, with the result that SAIC was forced to withdraw its management from the Ssangyong plant.

On the downstream distribution side, Chinese firms also need to develop their understanding of local customs in order to succeed in their business abroad. What is seen as customary in China may be considered very strange on another continent. Thus understanding consumer behaviour has been a genuine difficulty for Chinese firms, which may not easily be discovered after entering the new consumer territory. For example, one of the most famous Chinese automotive SOEs set a very aggressive annual sales target for the year in which it entered the European market, but it had not observed consumer habits well enough before establishing its sales channels. In China, car purchases are mostly made as one-off payments to dealers, whereas European customers habitually use finance to divide their payments and use local banks to transfer their funds to dealers. Having not understood this market dynamic, the SOE had not put in place deals to make finance options or loan services available with either a local bank or foreign branch of a Chinese Stated owned bank. As a result, their actual annual sales were 10 times less than what they had targeted.

CONCLUSION

In the light of their increasing overseas activities, there is no doubt that Chinese firms play a significant role in China's foreign-economic policy. On the one hand, most Chinese firms benefit from both monetary and political support from the government. They are encouraged to act aggressively across the world to acquire natural resources and cutting-edge technologies. On the other hand, as firms, their close links with the government have hindered their business plans, as they have made economic and political compromises both at home and abroad in order to fit with Beijing's priorities.

Chinese companies are particularly vulnerable – not to mention complacent – when they operate abroad. Some Chinese firms simply assume that acquiring a foreign company represents success, and treat it as an end by itself. However, the really tough challenges they have faced arise from post-merger management and market entry, as firms struggle to adapt to new and unanticipated situations without the Chinese government's interventions and protection. Chinese firms are relatively new players in initiating foreign direct investments in other countries, having previously been more accustomed to being recipients of Foreign Direct Investments. As investors, they still have had a long way to catch up. China's competence in 'buying up the world' has been grossly over-estimated by the West. ■

China's Strategy towards the Financial Crisis and Economic Reform

Linda Yueh

China's pragmatic attitude towards its own 30 years of reform can be used to similarly characterise its attitude toward the global financial crisis of 2008 and the resultant push for further economic reforms. China was able to manage the downturn following 2008, and has a good chance of managing the consequences of Europe's slowdown by undertaking fiscal and monetary stimulus. The debate over global imbalances has increased the need for nations to re-balance their economies, including China. The Chinese economy requires re-balancing to sustain strong growth rates in the coming decades, with the slowdown in the West making the re-orientation towards growth by domestic demand an even greater imperative.

RE-BALANCING THE ECONOMY

The 20 million workers who lost their jobs in the export sector and the damage to Chinese GDP during the 2008 global financial crisis have increased the impetus behind the already planned re-balancing of the Chinese economy. The 12th Five Year Plan is focused on transforming the economy into a more sustainable model, so that the country can grow well for another 30 years.

The structure of the Chinese economy can evolve to become more akin to the United States and Japan, which are both large economies whose growth is primarily driven by domestic demand, but which are at the same time among the largest (third and fourth, respectively) traders in the world. In 1990, China was closer to the structure of the economies of the United States and Japan in that exports accounted for 12.9 percent of GDP in China and around seven percent in the United States and Japan. Since then, the success of the 'open door' policy has seen China's economic balance come to resemble that of Germany. Exports in 2007 accounted for 56 percent of Chinese GDP and for 76 percent of German GDP (though it should be noted that intra-European trade in the single market accounted for around three-quarters of German trade). In 2009, when global trade contracted for the first time since World War II – by 12.2 percent according to the WTO – both Germany and Japan experienced recessions that were deeper than in the United States, the epicentre of the financial crisis. In China's case, despite large-scale redundancies in export industries, a technical recession was avoided through swift implementation of fiscal and monetary stimulus that succeeded in significantly increasing domestic demand.

China could reduce its exposure to the volatility of the world economy by following a path to strengthen both internal and external demand, which would increase the portion of growth driven by domestic demand even as trade expands in absolute terms. Such restructuring will allow China to continue to benefit from global integration, which includes learning from the technological advancements of developed economies, and to continue its 'catch up' growth, while maintaining a larger base of domestic demand to shield it from the worst excesses of external shocks.

Reorienting towards domestic demand means boosting consumption in China, that is, reducing households' and firms' tendency to save. Consumption fell from around 50 percent of GDP in the 1980s and early 1990s to just under one-third by the late 2000s. In developed economies, consumption is typically between half and two-thirds of GDP, for example, in Germany it is 58 percent, Japan registers 60 percent and it was 72 percent in the United States on the eve of the 2008 global financial crisis (the latter was generally considered to be too high).

For Chinese households, precautionary savings motives are important to address, particularly in rural areas, so China needs to make substantial investment in social security provision. There were some measures in the government's stimulus plan of 2009, which increased health and pension spending, but more is needed. Developing the service sector will also boost domestic demand by increasing the non-tradable component of the economy, and by creating jobs in both the low and high-ends of the skills spectrum. Furthermore, increasing urbanisation can improve the earning potential of rural residents and boost consumption. Indeed, wage bills that have lagged behind output growth reduced workers' share of national income, which in turn depressed consumption and caused it to shrink as a share of GDP.

There has also been an increase in savings by firms (both state-owned and non-state-owned) during the 2000s. China's distorted financial system is biased toward state-owned enterprises (SOEs), and private firms have trouble obtaining credit – either from banks or China's underdeveloped domestic capital markets. Therefore, private firms rely heavily on retained earnings to finance their growth. SOEs, on the other hand, save because of the minimal taxation of their profits. These distorted incentives towards saving for firms meant that when China's current account surplus was near 10 percent of GDP after 2004, China's investment maintained its share of GDP, even though investment is typically squeezed when countries develop a current account surplus. Consumption dropped as the motives for saving were undiminished by the export boom, and total savings rose instead.

DOMESTIC REFORMS

The policy reforms needed to increase aggregate demand in this framework centre on reducing the savings rate of households and firms to generate higher output in the context of a smaller trade surplus. Greater government spending can also increase consumption and investment if undertaken to support private incomes and the efficiency of capital markets.

Household savings have averaged 19 percent of GDP since 1992, following the significant opening of the Chinese economy, and the associated decline in domestic consumption's share of GDP. Savings were already high, but they increased by a further eight percentage points after 2000, rising to 22 percent of GDP by 2007 at the onset of the global financial crisis. For firms, the average savings rate was lower – at around 15 percent of GDP between 1992 and 2007 – but this grew quickly to reach 22 percent of GDP by the mid-2000s. The remainder of Chinese savings derives from government, whose savings rate doubled from 5.2 percent in 2000 to 10.8 percent in 2007. Taken together, China's savings rate increased from 38 percent of GDP in the 1990s to a peak of nearly 52 percent by the late 2000s. Startlingly, the savings rate increased by 17 percentage points during the first decade of the 21st century, mirroring the fall in consumption as a share of GDP from around 50 percent of GDP in the early 1990s to 35 percent by the late 2000s.

Therefore, for households, addressing the savings issue centres on lagging wage and income growth; while for firms, reforming capital markets is critical. For households, income growth and removing the motives for precautionary savings would bring down the savings rate. Industrial output has grown at 14.1 percent on average per annum for 20 years since 1988, but wage growth has not kept pace. Industrial output grew at double the previous pace in the 2000s, averaging 23.1 percent per annum. Yet, the average annual real wage growth of urban employees was lower, at 11.9 percent over the period between 1995 and 2008, and a paltry five percent during the late 1990s. Rural incomes have risen even more slowly.

In the 2000s, average wage growth was faster at 14.9 percent per annum, but against a backdrop of industrial output growth exceeding 23 percent each year. Thus, because labour income has lagged behind output growth, consumption has fallen as a share of GDP.

Moreover, labour productivity has increased seven-fold from 1980 to 2005, according to the International Labour Organisation (ILO), which suggests that wages do not match the marginal product of labour. Labour productivity has been improving in the 2000s since the significant reform of labour markets at the end of the 1990s, and the improvement has been hastened by recent supply-side tightening. The protests in 2009/10 over low wages, and a reluctance of rural migrants to return or move to the cities, reflects the potential for increased wage growth to match the marginal output of labour. In so doing, there need not be inflationary pressures so long as higher wages prompt growth in labour productivity that matches any future wage increases and instead can increase incomes and boost consumption.

Other measures that can ease labour market tightness involve removing restrictions on mobility, that is, increasing urbanisation by allowing migrants to settle in urban areas. It would reduce segmentation in the labour market and increase the mobility of workers to find matches to appropriate jobs and not be barred by geographic or *hukou* (household registration system) barriers. Urbanisation is a policy that has been proposed alongside renewed efforts to develop the services sector. The services sector increased steadily as a share of GDP from 23 percent in 1979 to 40 percent in the 2000s but has not developed further. China has a lower share of services in GDP than comparably-sized economies where the services sector accounts for more than half of GDP (for example, in the United Kingdom it is over 80 percent). Services is a non-tradable sector as it includes items such as hair cuts and government services, and would help to increase both domestic demand and reduce savings if such service provision included the delivery of social security. Thus government spending on services can significantly reduce the savings rate of the economy while boosting domestic demand and incomes. Urbanisation further allows the delivery of services to be distributed more efficiently such that there can be greater economies of scale. For instance, health, pensions, unemployment, local services, and schools can all be developed as part of the services sector along with the infrastructure needed to support this development, which in turn increases the efficiency of investment and associated industrialisation in the urban area.

Together, internal and external sector reforms would improve the efficiency of the urbanisation process by reducing the cost of imported inputs. It would further help on the income side for households since a stronger renminbi would reduce the cost of imports, particularly food, and increase disposable income. Removing the ‘ceiling’ on deposit rates would also increase interest income to households, which has plunged into negative territory, with inflation exceeding the deposit rate in the late 2000s. The combination of internal and external re-balancing would thus assist with reducing household savings and increase output.

FINANCIAL REFORMS

Further liberalisation of interest rates would improve credit allocation to non-state sector firms and reduce the savings incentive for firms too. Although interest rates were partially liberalised, including in 2004 when the ceiling on inter-bank lending rates was lifted, there are still limits in terms of the ‘floor’ on the lending rate. Interest rates reflect the internal rate of return to investment, so such controls distort lending decisions. These restrictions preserve bank margins in the same way that capital controls preserve the deposit base, but they lead to high rates of corporate saving.

Such reforms should render the allocation of capital more efficient even though the rate of investment may not increase, suggesting greater output for the same amount of invested funds. Returns on assets are high in China, but they are greater for all types of private firms than for SOEs and collectives. Yet SOEs continue to receive disproportionate amounts of credit despite being less productive. Without interest rate liberalisation and further reforms of the financial system, the extent of financial repression distorts credit allocation and induces saving by private firms, which contributed as much as that by households to the increase in the savings rate in the 2000s. Wages below the marginal product of labour generate profits, but capital market reform will reduce the distortions to firm savings behaviour, particularly if it is linked to capital account reform.

CHINA'S OUTWARD INVESTMENT

Gradual capital account liberalisation, in particular the 'going out' policy that is encouraging Chinese firms to operate as multinational corporations, can reduce savings if firms are permitted to operate in global markets and are allowed to access funding from better-developed overseas credit markets. In other words, firms can raise money on capital markets and not just rely on China's banking system with its controls on credit.

More generally, state-owned enterprises and increasingly private firms have been encouraged by the Chinese government to 'go out' and compete on global markets. Launched in 2000, 'going out' is intended to create Chinese multinational corporations that are internationally competitive. By doing so, China aims to become more than a generic producer of low-end manufacturing goods, branded under the moniker of Western firms. Its firms' ability to be as innovative and productive as leading global companies is an indicator of industrial upgrading, the very thing that China needs to ensure a sustained growth rate.

For instance, Haier is the largest white goods maker in China, and although it is sold in Walmart it does not command brand recognition and loyalty in world markets. The strategy of Lenovo, therefore, was to not only purchase IBM's PC business but also to license the use of the brand name for five years so that Lenovo can eventually assume the trusted name of IBM in world markets. These are all developments which took place starting in the mid-2000s, when the first commercial outward investment by a Chinese company was permitted in 2004 with the purchase of France's Thomson by electronics firm TCL.

Most outward Foreign Direct Investment (FDI) remains state-led investments in energy and commodities, but the maturing of Chinese industry indicates that the trend is changing as China seeks to move up the value chain and develop multinational companies that can follow in the footsteps of other successful countries like Japan and South Korea. These countries, unlike most developing countries, managed to join the ranks of the rich economies through possessing innovative and technologically advanced firms that enabled them to move beyond what is sometimes termed the 'middle income country trap', where nations' growth slows as they reach a per capita income level of $14,000. The process of growth through adding labour or capital (factor accumulation) slows or reaches its limit, and they are unable to sustain the double digit growth rates experienced at an earlier period of development. By increasing productivity instead through developing industrial capacity and upgrading that is stimulated by international competition, it is more likely that a country can maintain a strong growth rate. The need for energy as well as upgrading industrial capability is the motivating forces for China to invest overseas. Nevertheless, by the end of the 2000s, the share of commercial outward investment remains small whilst state-owned firms continue to constitute the bulk of outgoing FDI. The shape of things to come, though, points to China becoming a net capital exporter: the process of its firms 'going global' could herald an era of Chinese multinational corporations.

There has been explosive growth of outward FDI since the mid-2000s, due not only to SOE investment in commodity sectors but also to commercial mergers and acquisitions of private companies like Lenovo, which purchased the IBM PC business for the then-record of $1.75 billion in 2005, later surpassed by Geely's acquisition of Volvo for $1.8 billion in 2010. Becoming a net capital exporter is also viewed as a marker of a country reaching a level of industrial development where its firms are able to operate and compete on world markets. With outward FDI accelerating and close to overtaking inward FDI by the end of the 2000s, China could be on track to demonstrate that its industrial capacity is not only a function of foreign invested entreprises producing its exports, but indicative of a more widespread upgrading of its industry. The policy aim of 'going out' or 'going global' looks to be being realised at the end of the first 30 years of reform.

There are also a number of macroeconomic benefits. Capital account reform would not only reduce the motive for corporate savings but also cut the portion of the current account surplus that is funded through the purchase of US Treasuries by allowing capital outflows in the form of investments instead of accumulated in foreign exchange reserves. The exchange rate should also become more flexible with greater capital account liberalisation since the capital account and the current account will require the renminbi for transactions. Recent measures to increase the use of the renminbi in trade arrangements already point to the growing internationalisation of the Chinese currency. Therefore, exchange rate and interest rate reforms together should produce a better balance between China's internal (savings and investment) and external (balance of payments) positions and help to re-balance the economy.

CONCLUSION

China can be a fast growing, large, open economy – developing domestic demand and upgrading industry and promoting globally competitive firms – that recognises its wider impact because it is unlike small, open, export-led economies which do not affect the global terms of trade. Given China's still low level of development, global integration would benefit its own development as well as that of the world. These macroeconomic reforms will be important to position China optimally in a global economy that is significantly different and more uncertain than before. By doing so, China could grow well in the years to come. It may have done something extraordinary in growing strongly for 30 years, but at per capita income levels of just $4,200, there is still considerable scope for 'catch up' growth and thus the importance of not only attracting investment via the 'open door' policy, but also the increasing emphasis on 'going out.' By so doing, its global investments and corporations will affect the contours of the corporate sector internationally.

Global imbalances have existed for some decades and their exacerbation in the 2000s formed the backdrop to the worst financial crisis in a century. In the short-term, the world has already somewhat re-balanced with the US current account deficit falling from six percent to around three percent of GDP in 2010, and savings rising in recessionary countries. This further implies that China and other countries will need to re-balance their economies to sustain the rate of growth of the 2000s, which was driven by strong US imports and demand.

For surplus countries like China, loose American monetary policy can be transmitted via fixed exchange rates, which leads capital to flow from low to high interest rate economies. Thus, China should gradually reform its exchange rate to prevent domestic asset bubbles such as those that have occurred in the non-tradable real estate sector. Increasing the flexibility of the renminbi exchange rate before tightening monetary policy will also be important as an increase in the interest rate in China – while the United States Federal Reserve is committed to maintaining a near-zero interest rate – will only worsen the capital inflow, eroding the impact of tightening measures.

Therefore, reforming the exchange rate and the interest rate can induce higher output growth if the switch to higher consumption can be managed while the trade surplus is smaller. The continuation of global imbalances further implies that such liberalisation must be carefully regulated to prevent destabilising capital flows as global liquidity will remain an issue. Re-balancing China will not correct global imbalances, but the acute management of the trade surplus along with a recognition that such action will have some effect on re-balancing the global economy will mean a more sustainable growth path for China and perhaps the world economy. In other words, China's policies towards re-balancing are promising steps to transform its economy into a stable and prosperous society with positive benefits for the rest of the world. However, it will need to decide that it will aim to become a large, open economy and decisively move away from excessive reliance on export-led growth, which is more feasible in any case at this stage of development. China's decision on that front will shape its destiny in the coming decades. ■

China's Approach to US debt and the Eurozone crisis

Nicola Casarini

The sovereign debt crisis and the economic predicament of the West elicit mixed feelings and attitudes in China. On the one hand, the spiralling debt and worsening market conditions of the US and the eurozone are affecting China's export-driven economy significantly; on the other, the crisis in the West provides Beijing with the opportunity to raise its profile internationally and challenge the existing international economic and monetary order. China's financial resources are sought after, both to contribute to solving the eurozone's debt problem and to continue sustaining the America's structural deficit. Beijing has protected its position as the largest investor in US treasuries by disinvesting away from dollar-denominated assets and increasing its holdings of the euro. Risk in the eurozone has been offset by reallocating Chinese purchases of bonds away from peripheral countries and into the core members, in particular Germany. Moreover, China has increased its investments in European industrial and infrastructure projects that guarantee safer returns. The debt crisis is changing global power relations: Chinese leaders are today, for the first time in modern history, in the position to take advantage of the West's economic woes while also lecturing American and European policy makers on their economic and fiscal policies.

CHINA AND US DEBT

Since the beginning of the subprime mortgage crisis in 2007 and following the collapse of Lehman Brothers in September 2008, Beijing has closely monitored the state of the US economy, China being the largest foreign investor of US treasury bills and other US securities. In Autumn 2010, China's Dagong Global Credit Rating Company decided to downgrade the US to A+ (4 levels lower than AAA) when the US Federal Reserve decided to continue its policy of quantitative easing. In Chinese eyes, this is essentially a way for the US to print money, with the associated risks of debasing the currency and setting off inflation in emerging markets. With this debt monetisation and its zero interest rate policy, the Fed is in reality devaluing the US dollar, making it easier for the US to service its debt. This forces foreign investors like China to keep rolling over debt to avoid realising currency losses on their investments.

Since Beijing holds a significant amount of US government debt it risks suffering major losses as a result of any dollar depreciation. These investment losses would limit the financial flexibility of China at a time when it is most needed for rebalancing its domestic economy and growth model. The damage could also lead to political instability, as the Chinese blogsphere is fiercely critical of the central government and its management of China's foreign reserves.

Furthermore, low interest rates and the falling US dollar have encouraged investors to increase investments in emerging markets, which offer better returns and higher growth prospects. These flows have pushed up asset prices and currency values, distorting economic activity and leading to inflation in China. The People's Bank of China has had to intervene several times in recent years to increase interest rates and restrict bank lending.

A weaker dollar allows the US to regain its competitiveness by making its products cheaper. Yet this seems to have helped America's exports and growth only partially. US debt has continued to increase in the last few years, raising further doubts about Washington's capacity to service it in the future. These concerns were highlighted on 5 August 2011 when Standard & Poor's downgraded the US sovereign credit rating by one notch from AAA to AA+. The other two major rating agencies, Moody's and Fitch, maintained America's AAA rating. Following Standard & Poor's' downgrade, the Chinese Dagong subsequently further lowered the US to a single A, indicating heightened doubts over Washington's long-term ability to repay its debts. Dagong has also downgraded Germany, France and the UK, assessments not shared by the major Western credit rating agencies.

Standard & Poor's justified its downgrade by citing 'political brinkmanship' in the US debate over the debt ceiling, as well as concern about the federal government's ability to manage its finances in a stable, effective and predictable way. The planned $2.1 trillion in budget savings 'fell short', according to Standard & Poor's, of what was required to reduce the nation's debt to more manageable levels. This assessment was largely shared by the Chinese government, which is increasingly worried about the security of Chinese savings massively invested in US treasuries and other US dollar securities.

What worries China is that recent US economic growth has been debt-fuelled. Since 2001, borrowing has contributed to around half the recorded economic growth in the American economy. By 2008, $4 to $5 of debt was required to create $1 of growth. A reduction in debt reduces growth, which in turn makes the level of borrowing more difficult to sustain. China, as the major investor in US government bonds, finds itself in the position captured by John Maynard Keynes: 'Owe your banker £1000 and you are at his mercy; owe him £1 million and the position is reversed.'

A MARRIAGE OF INTEREST: FOR HOW LONG?

After the US downgrade in August 2011, the Chinese government issued a statement indicating its hope that 'the US government will earnestly adopt responsible policies to strengthen international market confidence, and to respect and protect the interests of investors'. The People's Bank of China continues to purchase US government debt as part of a giant global liquidity scheme. Chinese foreign reserves have been growing from dollars received from exports and investments that had to be exchanged into local currency. In order to avoid increases in the value of the renminbi that would affect the competitive position of Chinese exporters, Beijing has massively invested its reserves in US dollar-denominated assets, primarily US Treasury bonds and other high-quality securities. Until summer 2011, China typically purchased around $1 billion of US Treasuries a day. In this way, China has been fuelling American growth by both supplying cheap goods and providing cheap funding to finance the purchase of these goods. It has been a mutually convenient alliance of interests: China has financed customers creating demand for exports and America has received the money to buy Chinese goods. But following the worsening of the global financial crisis, Chinese worries about the sustainability of US debt have increased, leading the Chinese government to diversify risk away from the dollar. After US downgrade in August 2011, the *Xinhua* news agency called explicitly for an end to American hegemony over world markets and for international supervision of US printing of new dollars. It went further to argue that China 'has every right now to demand the US address its structural debt problems and ensure the safety of China's dollar assets', maintaining that America needs to cut 'its gigantic military expenditure and bloated social welfare costs' to cure its budget deficit.

A solution to America's debt problem is indeed to bring the federal budget deficit down, through spending cuts, tax increases or a mixture of both. In 2011, the major categories of government spending were defence (24 percent), social services (44 percent), non-defence discretionary (25 percent) and interest (7 percent). The US defence sector captures almost a quarter of the federal budget, which is largely financed by foreign investors like China. Ironically, it is toward

Beijing that the US military is now turning its attention. Chinese concerns about the US debt crisis coincide with Washington's worries about Chinese military modernisation which are leading the US to overhaul its security posture in the Asia-Pacific.

On 5 January 2012, President Barack Obama and Leon Panetta, US Secretary of Defense, released the new Strategic Guidance, maintaining that the US military 'will of necessity rebalance toward the Asia-Pacific region'. This is in keeping with the broader 'pivot' toward the Asia-Pacific, illustrated by Barack Obama's trip to the region in November 2011, as well as progress toward the Trans-Pacific Partnership (TPP) economic agreement and plans to rotate US military forces through bases in Australia, moves that many Chinese analysts have interpreted as aimed at countering China's growing power and influence. The new Strategic Guidance reflects a commitment to maintain the US military's ability to operate effectively in the region and to continue to act as the guarantor of Asia's public goods and security. However, the US strategic pivot toward the Asia-Pacific makes China's bid for regional hegemony impossible. America's new defence posture thus prepares for eventual hedging activities against Beijing, should China's assertiveness and newly-acquired capabilities be used to undermine US strategic interests in the area. It may only be a coincidence, but China's diversification of its foreign reserves, which began in earnest after the US downgrade in August 2011, has accelerated in recent months following the announcement of the US pivot to Asia and the issuance of the Pentagon's Strategic Guidance clearly aimed at keeping Beijing in check. China's holdings of US treasuries at the end of January 2012 were $1.156 trillion, or 23 percent of total US treasuries, down of more than 5 percent from 28.2 percent in July 2011.

AWAY FROM THE DOLLAR

According to data released in March 2012 and published in the specialised press – including The Wall Street Journal and the Financial Times – while overall foreign demand for dollar securities has remained strong, the percentage of dollar holdings in China's foreign reserves has fallen to a decade-low of 54 percent in 2011 from 65 percent in 2010. Purchases of US securities accounted for just 15 percent of the increase in China's foreign exchange reserves in the 12 months, down from 45 percent in 2010 and an average of 63 percent over the past five years, according to information published by the US Treasury and the Chinese government.

This trend runs counter the approach adopted by the other world's major central banks. According to a poll by Central Banking Publications – a London-based company that specialises in reporting on central banks – the portion of allocated reserves held in dollars rose from 60.5 percent in the second quarter of 2011 to 62.1 percent by the end of the year while the portion of central banks' (excluding China) allocated reserves held in euros fell from 26.7 percent to 25 percent over the same period, results that are supported by IMF data. In the same period, however, the portion of the People's Bank of China's (PBOC) allocated reserves held in euro-denominated assets rose from around 27 percent to 33 percent. This indicates that China is adopting a contrarian strategy – compared to the other major central banks – to aggressively diversify its reserve portfolio away from the dollar. This trend confirms Chinese Premier Wen Jiabao's declarations that the euro is currently the prime target of China's purchases. The numbers above are significant in as much as Beijing has accumulated the world's largest foreign reserves (around $3.3 trillion at the end of March 2012).

The main beneficiary of this diversification strategy has therefore been the euro, which now accounts for around one-third of China's foreign reserves, up six percent from summer 2011. There has been a reallocation, though, of Chinese purchases of eurozone bonds, away from peripheral countries such as Portugal, Ireland, Italy, Greece and Spain and into the more secure core members of Germany, France, Austria and the

Netherlands. This is in line with the statement issued by Zhou Xiaochuan, governor of PBOC, on 12 March 2012, about the need for Beijing to make continued efforts to manage the country's reserve assets with 'new ideas' and in a more 'effective' manner. In other words, China will continue to diversify its investments in foreign bonds away from the US dollar and into the more secure (i.e. AAA-rated) eurozone's core members, while keeping risk control a top priority. China seems to put more trust in Europe's economy – in particular Germany – than in the US. This is also reflected in trade patterns: EU-China bilateral trade is growing at a sustained pace, with Sino-German trade alone surpassing €100 billion in 2011.

A strong euro benefits China's export-driven economy by putting downward pressure on China's currency, and is instrumental for lessening the predominant position of the dollar. Furthermore, the US pivot to the Asia-Pacific and the new defence strategic guidance clearly aimed at Beijing are pushing Chinese leaders into multiplying the diversification of its economic and political interests – and connections – to hedge against an eventual US-led encirclement strategy. In this vein, the diversification of Chinese foreign reserves away from the dollar and into the euro also includes elements of support for the EU and its integration process as a counterbalance to America's primacy.

CHINA AND THE EUROZONE'S DEBT CRISIS

Chinese leaders have approached the eurozone's sovereign debt crisis through the lens of their long-standing support for a stronger and more united EU that could work alongside Beijing to counter American hegemony, including challenging the dollar's 'exorbitant privilege'. China has supported plans for a European single currency since the beginning, as part of its desire to create an international currency system where the dollar would be less dominant. In 2009, the PBOC governor explicitly called for the creation of a new international reserve currency. In the meantime, for Chinese policy makers the euro represents the strongest alternative to the dollar, with Beijing having been one of the first buyers of the new currency, starting a process of diversification of its reserves that continues today.

It is in this context that China has voiced concerns about the eurozone's sovereign debt crisis. The EU is China's most important export market, and since the mid-2000s, China has been the EU's biggest source of imports. In 2011, EU-China trade amounted to €428 billion, yet the economic downturn in Europe is seriously affecting the Chinese manufacturing sector. It is therefore in China's interest to continue sustain the value of the euro, since by doing so, it keeps the value of the renminbi down, thus helping the competitiveness of Chinese products.

The survival of the euro is also politically crucial for China's multipolar strategy. Chinese officials have intervened on a number of occasions since the beginning of the eurozone's debt crisis to reassure markets and the Europeans that they will continue to buy eurozone bonds. Chinese investors, for instance, have continued to represent a strong proportion of the buyers of the Portuguese bail-out bonds being auctioned by the eurozone's €440 billion rescue fund, and Beijing has also showed an interest in investing in fully guaranteed and safe (i.e. AAA-rated) eurobonds once they become reality.

This continued interest in euro-denominated assets should not be interpreted, however, as an endorsement of how Europe has been handling the debt crisis in some eurozone countries. The primary motivations lie in finding new, safe investments into which to put China's growing reserves, sustaining its most important export market, and diversifying risk away from the US dollar. Beijing has agreed in principle to participate in the international efforts aimed at solving the eurozone's debt crisis, a promise that Chinese leaders reiterated in 2012, during the visit of Angela Merkel to China in early February, on the occasion of the EU-China Summit on 14 February, and the visit of Mario Monti to Asia at the end of March. Yet, no official commitment has been made as to the amount that China is ready to make available for the eurozone's rescue fund through the IMF.

Moreover, Chinese leaders have attached some conditionality to their participation in any solution of the eurozone's sovereign debt problems, reiterating its demand that the EU 'puts its house in order'. In September 2011, Wen Jiabao also indicated that the granting to China of Market Economy Status

(MES) and/or lifting the EU arms embargo would be regarded favourably by both Chinese leaders and citizens and thus help support China's bailing out of rich Europe. In practice, China's contribution, rather than simply bailing out the eurozone, has taken the form of growing investments in industrial assets and infrastructure projects across Europe.

Analysts at Grisons Peak Merchant Bank found that Chinese FDIs in the EU have soared by 297 percent in 2010 (compared to 2009) to reach $2.13 billion. Europe is proving more fertile ground for Chinese investments than the US: China's total investments in Europe are 53 percent greater than the $1.39 billion that went to the US in 2010, according to the Chinese Ministry of Commerce. However, the amounts invested so far come to less than 5 percent of China's global overseas foreign direct investment. Chinese purchases in Europe are likely to expand in the future as the debt crisis in some eurozone members provides investors with lucrative opportunities. To this end, in March 2012 the Chinese government injected $30 billion into the China Investment Corporation (the Chinese sovereign wealth fund) to be used specifically for acquiring industrial and strategic assets in Europe.

THE PROPENSITY OF THINGS

China's economy is suffering as a result of the debt crisis in the US and in the eurozone. Yet Chinese leaders have also succeeded in turning some of the elements of the crisis to their advantage. China's strategy of diversifying its foreign reserves away from the dollar and into the euro contributes to China's long-term goal of lessening the dominant position of the dollar to create a multipolar currency system, in which the renminbi will also have a role to play. At the same time, China's support for the eurozone and growing investments in Europe allow Beijing to obtain valuable technology, knowhow and brands, to be used to further the country's economic modernisation and development. This differentiated approach toward the US and the eurozone's debt crisis appears in line with the Chinese traditional concept of *shi* – to exploit the propensity of things in order to achieve the desired goal. ■

What Power Shift to China?

Guy de Jonquières

That economic and financial power is shifting from West to East – and specifically to China – has become a mantra of our age, repeated so often and so insistently that it appears to be widely regarded as self-evident. Frequently, it is accompanied by the assertion China is set irreversibly on the path to global pre-eminence, if not outright domination. It is only a matter of time, it is sometimes suggested, before China rules the world.

Exactly what China's power consists of, how it might be exercised and for what purposes are left tantalisingly unexplained. It seems simply to be assumed that such a populous country, whose economy has grown so big so fast, must have both the will and the capacity to impose its writ on the rest of the world. But that assumption, and the premises that underlie it, are highly questionable.

Undeniably, three decades of double-digit growth have given China impressive economic scale. It is the world's second biggest economy, creditor nation and importer, its largest exporter and, by some measures, its most important manufacturing centre. It has the biggest current account surplus and foreign exchange reserves – at more than \$3,000 billion, roughly one third of the global total. And it is the world's biggest consumer of such commodities as aluminium, iron ore and copper.

However, those achievements need to be set in perspective. A hundred years ago, well before it became a global superpower, the US had already been the world's biggest economy for a decade and accounted for a fifth of world GDP, considerably more than twice as much as Germany and Britain, the next largest economies, combined. On the most generous purchasing power parity (PPP) measure, China's GDP today is only two thirds that of the US – and less than half at nominal exchange rates – and its growth rate is set to slow in the coming years.

Furthermore US incomes a century ago were the highest in the world, almost 10 percent more than those of Britain, its closest rival. Chinese incomes today are barely one-sixth of the US level on a PPP basis, and only one tenth at nominal exchange rates, and ranks about 90^{th} in the world league table. Relative to other countries, China now is a vastly poorer country than the US was then.

In any case, economic size does not, of itself, confer international influence. Japan, at its economic apogee in the 1980s, had the world's second largest GDP, a huge current account surplus, bulging foreign exchange reserves and a world-beating manufacturing sector. Yet, despite widespread predictions that it was set to become a dominant power, it never translated those strengths into matching political or diplomatic influence, let alone leadership. And two centuries ago, when China was the world's biggest economy, with a GDP larger than the whole of Western Europe, it was largely closed off from the world.

It is true that the West's ability to influence China – insofar as it exists – is in decline. But that is as much because the financial crisis of 2008 has sapped the West's economic strength and moral authority as because of China's rise. No longer is China prepared to be lectured by those who once treated it as a precocious pupil, when their own affairs are in disarray and when, in Europe's case, they are looking to China to bail them out.

China's success in riding out the crisis and the West's economic weakness have inspired in it greater outward self-confidence, sometimes even hubris. Beijing has been emboldened to stand its ground more firmly in dealings with the rest of the world, in both bilateral and multilateral forums, from climate change talks to the G20, the International Monetary Fund and the World Trade Organisation. If China was ever amenable to bullying or coercion, it is noticeably less so today. It is also ready to use economic pressure to get its way with smaller or more vulnerable countries – for example by insisting that South Africa dis-invite the Dalai Lama from Archbishop Desmond Tutu's birthday celebrations last year.

Yet instances of China harnessing economic means to purely political ends are rare – and when it has tried to do so, it has often not succeeded: for instance, its attempts to get southern eurozone members to press Brussels to grant it Market Economy status in exchange for buying their debt have gone nowhere. Generally, China has proven a hesitant paymaster, apparently more interested in achieving secure prudential returns on its money than in using it to procure strategic geopolitical advantage.

It has responded coolly to more recent pleas to lend more to the eurozone, insisting that its governments first show they are serious about putting their financial house in order. It has also displayed a strong preference for channelling any future financial support through the IMF, rather than directly. This speaks not of a boisterous superpower eager to throw its weight about, but of an anxious investor wary of being sucked into a bewildering political and financial minefield and keen to have others lead the way.

One area where Beijing has attempted, with mixed success, to use economic muscle is in domestic industrial policy. It has sought, for instance, to compel foreign companies to hand over proprietary technologies in exchange for access to its market and to give indigenous producers an edge by seeking to impose national technical standards. However, the clear aim of such policies is commercial, not political, gain.

Beyond its own borders, the defining feature of Chinese power is defensive: the power to say no. That is not unimportant, when needy sovereign borrowers outnumber well-heeled lenders and when China's assent is essential to effective international cooperation in a growing number of fields. China is, however, strikingly reticent about contributing substantively to setting the global agenda, and even more so about plotting grand hegemonic strategies of the kind beloved of Western conspiracy theorists and some nationalistically-minded Chinese.

Such caution is in line with Deng Xiaoping's much-quoted injunction in international affairs to 'stand firmly, hide our capabilities, bide our time, never try to take the lead'. Though Beijing has recently deviated dramatically from that axiom in some areas of foreign policy, notably in its aggressive – and spectacularly counter-productive – outbursts towards East Asian neighbours in 2010, Deng Xiaoping's counsel of prudence continues to govern its economic and financial dealings.

Indeed, the rationalism that has long informed China's approach to economic affairs has repeatedly prevailed over recurrent pressures to give nationalism the upper hand in foreign policy. China's leaders know that if sabre-rattling and brinkmanship are allowed to get out of control, they could swiftly backfire, imperilling the stable international economic conditions on which the country's welfare and prosperity – and crucially, the regime's claims to legitimacy – hinge.

That is a point too often overlooked in discussion about China's impact on the world economy. In reality, the world economy's impact on China has been at least as great, if not greater. Indeed, in a number of respects, China today needs the West more than the West needs China. The most important is to generate demand and thereby growth.

China's rise has benefited raw materials exporters worldwide, but its relatively low level of domestic consumption limits its market for many goods and services of the kind made in the West. However, the West's markets still matter a lot to China.

The European Union is the biggest destination for its merchandise exports, accounting for roughly a fifth of the total; yet China buys barely a tenth of extra-EU exports, and their value overtook those to Switzerland only in 2010. Much as Western politicians may carp about China's surpluses on bilateral trade, they are actually a symptom of Chinese economic dependence.

CHINA'S FOREIGN ECONOMIC POLICY

Five main objectives underlie China's foreign economic policy, all of them heavily inspired by domestic concerns:

- Maintaining open world markets for its exports, more than half of which are produced by factories that are wholly or partly foreign-owned.

- Securing access to international supplies of energy and natural resources, to fuel the economy's industrial development.

- Insulating the economy and national wealth from potentially destabilising external shocks.

- Acquiring new technologies, knowhow and skills.

- Promoting the global expansion of national industries through investment abroad.

Those objectives are not always pursued in a consistent manner. The formulation of foreign policy in any country is complex, shaped by the interplay of diverse pressures and interests. They are especially difficult to disentangle in China, both because policymaking is highly opaque and because recent years have seen a rapid expansion of the number of foreign policy actors, whose relative influence can vary from case to case.

China's global quest for energy and natural resources is a case in point. This is sometimes portrayed as a concerted state-led strategy to secure sources of supply. In reality, it is driven as much by the ambitions of state-owned companies and their top executives, which effectively control much of the relevant policymaking machinery, and by scarce reserves and tight price controls at home, which force them to look abroad for profitable growth.

A remarkably small proportion of resources that Chinese companies extract or produce abroad – as little as 10 percent, in the case of crude oil – is shipped back to China: most is swapped or sold on international markets. Furthermore, as latecomers, Chinese resources companies necessarily focus heavily on regions where their Western competitors are not already entrenched or are, for one reason or another, barred from operating. Since most resources are fungible, the effect of Chinese companies' international expansion is not to 'lock up' supplies but, rather, to augment at the margin those available on world markets. That both casts in a different light scare stories about a supposed Chinese 'takeover' of resource-rich developing countries, and raises questions about the coherence of foreign policy.

Overall, China's external economic dependence has induced prudence. Recurrent tensions with Tokyo have been contained by Beijing's awareness of Japan's importance as a trade partner and valued source of advanced technologies, capital goods and investment. Equally, China has been adept, so far at least, at telegraphing tactical concessions designed to defuse pressures in the US Congress for trade sanctions over its exchange-rate policy. While its companies have stepped up acquisitions of assets abroad, they have been careful to avoid any rash moves that could trigger a Washington backlash of the kind provoked in 2005 by China National Offshore Oil Corporation's landmark hostile takeover bid for Unocal, the US oil company.

Admittedly, Beijing's embargo since 2010 on exports to Japan of rare earths, of which China is almost the only producer, in retaliation for the arrest of a Chinese trawler captain in disputed waters, is an exception from its traditional reluctance to use trade as an offensive weapon. It is still unclear whether this is an isolated incident or presages a shift to more aggressive economic diplomacy. However, it has not stopped China, Japan and South Korea moving ahead with plans for a free trade agreement nor thwarted discussions between Beijing and Tokyo on possible currency cooperation.

In any case, the export restrictions have so far proved ineffectual and may yet be self-defeating. Not only have they failed to cut off Japan's access to rare earths, which are freely smuggled out of China; the sharp price rise caused by Beijing's actions has spurred investment in production elsewhere that may in time break China's near-monopoly over supply of the minerals.

CHINA'S FINANCIAL TRAP

None of the trappings of supposed Chinese power excites greater international attention or discussion than its financial resources and, in particular, its massive foreign exchange reserves. These are frequently held up, at home and abroad, as emblematic of the country's economic strength and of its emergence as a heavyweight player on the global stage.

Yet that is not a view apparently shared by China's rich, many of whom seem to lack confidence in the future of its economy. Official as well as unofficial evidence suggests that wealthy individuals are smuggling ever larger sums abroad, while a survey of Chinese millionaires last year found that more than half wanted to emigrate in search of a better life.

Contrary to received wisdom, China's foreign exchange reserves are only partly a reward for economic success; they can equally be viewed as the product of skewed policies that have inhibited its economic performance. Their value has been swollen by large balance of payments surpluses that have built up since the early period of this century. These stem in part from net export earnings and capital inflows, but their principal cause is structural: a persistent excess of domestic savings over investment. Put another way, China's external surpluses have been acquired at the price of repressing domestic living standards.

There are several reasons for China's exceptionally high savings ratio. They include lack of a comprehensive social security system, which induces households to make precautionary savings to pay for retirement and ill-health; failure to tax and require dividend payments from state-owned enterprises; and a high savings rate by the government itself. Though Beijing acknowledges the need to tackle these challenges, it is moving only gradually to do so.

The reserves are dead money as far as China's own development is concerned, contributing nothing to national prosperity. They cannot in practice be spent at home, because converting them into renminbi would either trigger higher inflation or put strong upward pressure on the exchange rate – both outcomes that the government is anxious to avoid. They therefore have to be invested abroad.

However, finding a home for more than $3,000 billion is not easy. Few financial markets are large or liquid enough to absorb such vast sums easily – and most are in the West. As a big market player, furthermore, China cannot switch out of investments rapidly without risking substantial losses on them – and consequent fierce criticism from nationalistic sections of public opinion and the Communist party that view the reserves as precious patrimony.

The euro crisis has sharpened the dilemma. With as much as one quarter of its reserves in euro-denominated assets, China has a big stake in the health of the single currency. On the other hand, it is clearly reluctant to increase its exposure by propping up troubled, and in some cases insolvent, eurozone members through further large-scale purchases of their sovereign bonds – especially as their neighbours are balking at doing so.

In that sense, China is caught in a trap, to a considerable extent of its own making. It is less master than victim of circumstance, confronted with an array of awkward choices that circumscribe its room for manoeuvre. An emerging giant, maybe, but in some respects a muscle-bound one.

In search of an escape route and, in particular, of ways of reducing dependence on the US dollar, China is taking steps to promote international use of the renminbi. They include agreements with selected partners to use the currency to finance bilateral trade (chiefly China's imports), the launch of an offshore 'dim sum' bond market in Hong Kong, and authorisation of limited purchases of domestic Chinese bonds by Japanese investors.

So far, investors' response to these initiatives has been lukewarm. Not only do they appear to meet no strong commercial need, but they have offered little opportunity for profit and in some cases have been a recipe for losses. Indeed, market demand appears to have been heavily inspired by speculative short-term expectations of a further appreciation of China's currency and has subsided as those expectations have ebbed.

It is, in any case, unclear how much 'internationalisation' can achieve as long as China's extensive capital controls keep the renminbi unconvertible. A first, tentative step was made to address this issue in April, by widening the band within which the currency is allowed to fluctuate. However, moving to full convertibility could place enormous strains on China's primitive and ossified financial system, unless it were first radically overhauled and modernised. That may well be the real agenda of the policymakers promoting the 'internationalisation' of the renminbi, in the hope that it will increase pressure on a reluctant and divided Chinese leadership to launch the reforms needed to improve the efficiency of capital allocation and remove the severe distortions the system generates.

If so, they face potentially formidable obstacles. One is predictable resistance from powerful interest groups that benefit from the current system: local governments ; the banks for which it guarantees fat profit margins; and the state-owned enterprises for which it provides capital on preferential terms. More important still is opposition from conservatives in the political establishment who argue that financial liberalisation would not only destabilise the economy but, even more crucially, rob the Communist party of a vital lever of control.

Such arguments between liberalisers and conservatives extend well beyond the financial sphere. They are at the heart of the violent internal party conflicts waged in advance of the transition to a new leadership later this year. Their outcome is still unclear, but it seems certain to be of huge, possibly decisive, importance for the future conduct of Chinese economic policies, abroad as well as at home.

CONCLUSION

For three decades, China's approach to international affairs has been shaped by one over-arching imperative: the pursuit of rapid economic growth and development at home. That has placed a premium on maintaining stable external relations, above all with the US, while avoiding the distraction of foreign entanglements and leaving others to shoulder the burdens of global leadership.

The approach has served China well, freeing it to focus on pressing domestic priorities and challenges. However, it has also bred a distinctly inward-looking attitude that has prized preserving the status quo abroad and minimising the impact of disruptive external events at home. What China expects or desires from the world, beyond international respect and the fulfilment of its immediate material needs, remains unclear: Beijing is decidedly better at saying what it does not want than at identifying what it does.

Chinese diplomacy, likewise, has been ruled by the self-interested axiom of 'non-intervention' in other countries' external affairs – though how far it has been honoured in practice is debatable. Beijing has relied heavily for influence, especially in other developing countries, not on 'soft power' – a commodity in limited supply in China – but on the hard currency of money, investment, commerce and the promise of material gain.

Furthermore, in contrast to the US, China has few close allies, and those that it has – such as Burma and North Korea – have long counted among the world's undesirables. Its intentions often inspire suspicion elsewhere, and relations with fellow members of the BRICS are marked as much by differences as by common ground, preventing them from uniting even behind a candidate to head the World Bank. The fate of proposals to set up their own development bank and stand together in the IMF, discussed at the BRICS' summit in March, will be a test of whether their solidarity is more than rhetorical.

All this has left China cutting a somewhat isolated figure on the world stage, deliberately shying away from active engagement in issues that do not impinge directly and immediately on its most obvious national interests. That seems a narrow and unpromising platform from which to launch a bid to become the world's dominant power.

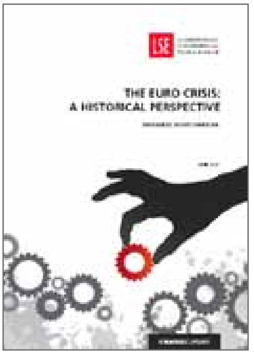
However, perhaps the most relevant question for the future is not whether China possesses the ambition or the capacity to achieve that goal. It is whether it can avoid being drawn into accepting more global responsibilities than it has so far been prepared to exercise – and how well it is equipped to carry them out.

The reason it may need to is, simply, that China's growing importance and its accelerating integration with the global economy will compel it. Not only does the impact of its own actions increasingly reverberate around the world, but its dependence on foreign sources of raw materials, energy, technology and markets increasingly expose it to complex and often unpredictable political developments beyond its own borders.

Relying on opportunistic use of the chequebook to further national economic interests, while sheltering on the diplomatic sidelines, is likely to become harder when, as in the Middle East, those interests can suddenly be placed in jeopardy by violent political upheavals. Equally, China's large stake in an open world trade system ought to provide an incentive to work more energetically to strengthen it, especially if it is threatened by a resurgence of protectionism.

Addressing these challenges would require making choices of a very different and more complex kind than those to which China is accustomed. It would also mean articulating a more wide-ranging and forward-looking vision of national self-interest that went beyond short-term expediency and meeting immediate material needs. Over the past three decades, China has shown that it can shake the established world order. It has yet to show that it can help shape a future one. ■

STRATEGIC UPDATES

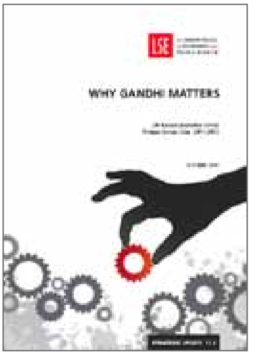


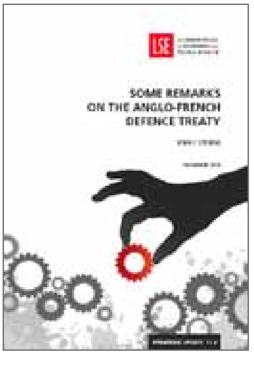
In this research report IDEAS explores the current euro crisis by looking at the debates preceding the conception of the euro. How can the early days of EU monetary cooperation help us understand today's predicament? And what lessons can we draw from them for the euro?

Emmanuel Mourlon-Druol is Pinto Fellow at LSE IDEAS.

This essay is a revised version of an address to the General Assembly of the United Nations, to mark the International Day of Non-Violence, observed every year on Mahatma Gandhi's birthday, 2nd October.

Ramachandra Guha is Philippe Roman Chair at LSE IDEAS.

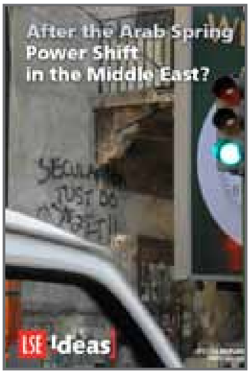




The signing of Anglo-French Defence Treaty has been one of the least reported, and analysed, of the UK coalitions Government's policies, whilst being, without question, one of its most significant. In the context of defence cuts on both sides of the Atlantic and the Channel, and of a Libyan operation in which Britain and France's dependence on American assets surprised some observers in Washington, this paper assesses the consequences of the Treaty for Anglo-French defence cooperation.

John Stevens is a Visiting Fellow at LSE IDEAS.

SPECIAL**REPORTS**

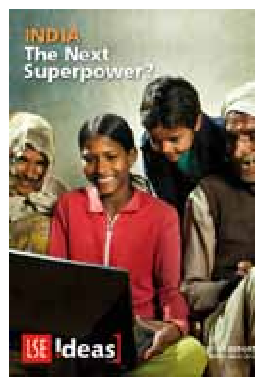


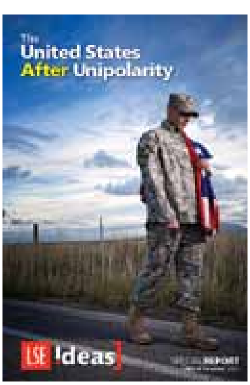
The events of the Arab Spring were an inevitable surprise. In a region where political oppression and economic under-development were most keenly felt among a demographic bubble of well-educated youth, the classic conditions for revolution were met. However, few could have predicted the spark that would ignite a wave of protest across the region. The final outcome of the protests across the region is still uncertain, but more than a year on, events have settled into patterns sufficiently to allow an interim assessment of their success.

This report finds little evidence to suggest that future historians will rank the events of 2011 with those of 1848, or 1989. Simply too few of the fundamentals of social, economic and political organisation in the Arab world have been successfully contested by the protests. As 2011's Spring turns into 2012's summer, the answer to the question of whether there has been a power shift in the Middle East, is a decisive 'not yet'.

When Hillary Clinton visited India in 2009, the US Secretary of State's verdict was unequivocal: 'I consider India not just a regional power, but a global power.' Following the success of economic liberalisation in the 1990s, which generated growth rates in excess of 8% and a rising middle class, expectations have grown that India might become a superpower, particularly in a West that sees in India's democratic heritage the potential for strategic partnership.

However, there remain deep and pervasive fault-lines within Indian society. Crony capitalism, the collapse of public health systems, a rising Maoist insurgency, and rampant environmental degradation all call into doubt India's superpower aspirations. Rather than seek to expand its influence abroad, India would do well to focus on the fissures within.





For the United States, the two decades after the end of Cold War could not have been more different: the first, a holiday from history amid a long boom; the second mired by conflict and economic crisis. By the end of George W. Bush's time in office, the United States' 'unipolar moment' was over, with emerging powers taking more assertive international roles as the United States looked to cut its budgets. Across a whole range of challenges, this waning of American dominance has defined Barack Obama's foreign policy.

international affairs

diplomacy

strategy

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