



Worth Noting

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Worth Noting is the journal of research and conferences company L21. It is focused on social, economic, political and international issues of relevance and interest to senior executives.

We have mentioned frequently that we believe the rise of China over the next couple of decades will be the most significant event that will shape and change international politics and economics during this time. This will be more important in international affairs than the 'War on Terror', rogue states, or even conflict in the Middle East. In particular, the strategic competition between the US and China will, we believe, define current affairs during the next generation.

Events over the past few years appear to back this up and we remain committed to this position. For some, China is moving forward inevitably and rapidly, from holding what many believe will be the most spectacular Olympic Games ever to an economy posting close to double digit growth towards burgeoning political and diplomatic power as evident in their leadership of the East Asian Summit. Shanghai has the feel of New York thirty years ago. The buzz in the city is unmistakable.

However, while much attention is given to the 'rise of China', much less is given to the challenges faced by China. These challenges and the responses to them by the Chinese will go a long way towards determining what kind of global power China will be. In this edition of *Worth Noting*, we thought it would be interesting to look at the most important challenges facing China.

Modernising is not as easy as they make out

China is committed to modernization. In the 1970s and 1980s, they aggressively pursued what they termed the 'Four Modernisations': in industry, agriculture, technology and defence. Their commitment and determination to expedite development is unquestionable and impressive. Their successes so far need not be mentioned. It is the fact that they have been so successful in modernizing that there is little disagreement that they will be a great power in the system.

In the eyes of many, the difficult part for the Chinese is over. From a peasant economy to the disaster of Mao's Cultural Revolution, the Chinese many argue have finally worked it out. They are racing towards a modern society and are doing it their way. Their economy is intimately tied to the rest of the world's economies. China has become a driving force for the prosperity of Asia. Their recent entry into the World Trade Organisation (WTO) is evidence of their standing.

It is true that the havoc wreaked on their society from the Cultural Revolution in the 1960s and 1970s when millions died has no modern comparison. China has gone way beyond those days. However, by wisely choosing to enter into the modern economic system, certain formidable problems must be confronted.

Prior to entering the WTO, China could do things their way without contest. By exposing their economy to WTO competition, certain weaknesses suddenly become more important.

First, China can less afford to protect their unemployed and largely unskilled workers, especially in agriculture. Many of these unemployed were previously (inefficiently) employed in State Owned Enterprises (SOEs). These SOEs are finding it difficult to stand up to open competition due to elements such as deflation in agricultural prices (e.g., lower priced products from more efficient producers in the US and Canada) and the grossly inefficient practices of most SOEs. Estimates of unemployment in the agricultural sector alone are between 80-140 million!

This has not occurred without incident. For instance, in 2000, 20,000 workers faced down the People's Liberation Army (PLA) to protest job losses. The PLA 'stabilised' the situation and serious violence was averted. Similar instances have occurred periodically through the

provinces since then, particularly in rural areas where job losses are the most serious.

This predictably has led to a mass migration from rural to urban areas fueling rising prices in urban housing prices. The rising urban house prices have provided a short-term boon for their banking sector. The story is a typical one: banks eagerly lend money to customers in a housing sector that seems insatiable. When customers keep on demanding more money to borrow, banks are the ones that cash in.

This has however created an extremely dangerous situation. China's banking and financial sectors are plagued by extremely poor accounting and risk management practices. Inadequate and weak asset portfolios are a systemic feature of almost all Chinese banks. Surviving only because of the demand led housing bubble, it is not an exaggeration to say that China's financial sector faces insolvency and probably collapse should the housing bubble burst anytime soon. Chinese authorities are becoming aware of this and are looking to completely restructure their financial sector. However, time is the key variable here. While house prices keep rising, banks will survive long enough for this restructuring to gradually occur. If there is even any sign of a bursting bubble, a cocktail of poisons will cripple the whole Chinese financial sector. Banks will become insolvent, inflation will be rampant, domestic capital flight will occur out of China at massive levels (unless the Chinese government freezes all domestic capital flight), and foreign investors will keep away from China. Foreign Direct Investment that supports China's export led growth will be decimated. The financial sector that fuels China's export led economy will be crippled.

They're getting older as well

There is also a demographic problem. If you think an aging population applies only to post WWII Western countries, you should think again. China will be the second country in Asia after Japan that will suffer a rapidly aging population in the coming decades.

From 2000 to 2007, the number of Chinese aged over 65 will increase from under 100 million to over 200 million (14 percent of the population.) If this sounds bad, consider that from 2028 to 2036, the number of people over 65 will surge from 200 million to over 300 million (20 percent of the population.) For a country that has had no effective plan in place to meet this challenge, this is a massive problem. There are no comparable central money pool or individual

super funds to meet the costs that will arise. There is also no history or tradition of saving money for retirement and estimates are that less than 50 percent of urban workers are financially preparing for their own retirements and care. The figure in rural areas is even worse.

This means that the government faces a stark choice: invest more in future nursing and aging services or invest more in the development of the country's economy.

The danger is from within

What about the famed ability of the Chinese to maintain coherence in a country of over one billion people?

So far, the PLA and Communist Party cohorts have worked together to maintain stability throughout the country. As the vanguard surge ahead with their modernization program, there will be winners and losers. Losers will include tens of millions of unemployed rural people in industries that cannot compete in a more open and modern economy and tens of thousands of lowly ranked soldiers from the PLA who will be cut as the army attempts to modernize and trim down their numbers.

Imagine the potential for civil unrest. There might be tens of millions of unemployed rural people moving towards major industrial areas dissatisfied with the modernization program. There might be many more million peasants on farms still surviving but dissatisfied with corrupt officials and illegal taxes on their land combined with the increased pressure of a more open and competitive economy. Finally, imagine the tens of thousands of soldiers who are losing their jobs and who enjoy the support of large numbers and powerful elements in the PLA who vehemently disagree with large manpower cuts in the military and who are vastly underpaid compared to civilian workers.¹ Dissatisfied former soldiers supported by large numbers of the existing military is a recipe for chaos.

These hypotheticals are not from a movie script. They are seriously considered by the Government at the highest levels. The threat of civil chaos and unrest is real. For example, during several massive demonstrations by thousands of workers laid off workers from 2000

¹ Junior soldiers make about 120 Yuan a year, and only a few young soldiers make more than 300 Yuan. In contrast, the average urban unskilled worker makes about 100 Yuan a month.

onwards, many of these workers had had military training and were putting it to use. Demonstrations were organized, logistics of the demonstration was professionally run and standard slogans from the PLA used by soldiers about the 'People's War' was adopted by the workers.

The interaction between disgruntled civilians and the military should not be surprising when one considers that there is a strong military presence inside China's 300,000 odd SOEs. As mentioned, the SOEs are a serious financial burden on the economy of China. SOEs employ about 100-120 million people and are operating at a loss of about 1 percent of China's GDP each year.

Because unemployment and insolvency in SOEs is a widespread problem, there is a problem with payment. Some SOEs pay workers in kind for their work, telling workers to sell the products on the open market. Others are paid only a part of what they are owed while some are frequently not paid at all. This means that workers often have to draw from their savings (exacerbating the old age savings problem).

Importantly, more than 1 million soldiers and officers in the reserve forces of the PLA work in SOEs. Often, whole divisions of reserve soldiers equipped with guns, vehicles, tanks and other weapons work in these SOEs. The potential for violent rebellion against conditions and policies is therefore very real.

As an instance, during the Tiananmen Square protests in 1989, a 10,000 strong fully equipped reserve army division unit was called in to help the PLA suppress the protestors. The reserve division were workers at the Capital Iron and Steel (Shougang) SOE. Rather than support the PLA, the vehicles and equipment of the reserve division were burnt a few miles from the Shougang factory. The strong suspicion is that this was done by both soldiers and members of the resistance behind the protests.

The problem with this scenario is that the potential for violence means that China's central leadership remains reluctant to dismantle most of the SOEs, hence exacerbating the economic problems.

Position of strength or weakness – China's foreign policy challenges

China also has significant external challenges. China publicly wants to be a 'great power' (i.e., a major player and influence in global affairs) and claims to be undertaking a 'peaceful rise'. The problem for China is that the 'peaceful rise' bit is not very strongly believed by countries warily watching China's journey.

If many in the West are paranoid about China, imagine how the Chinese leadership feels: they are hemmed in by US military alliances and US forward defence presences in Japan, South Korea, Taiwan and Philippines. Considering that Taiwan alone (with US equipment) is still able to hold out China, the US presence will effectively rein in any Chinese expansion plans for the moment.

There is no doubt that China is looking to increase its military bite. They are developing long-distance missile technology, a 'blue water' (long range) navy fighting and refueling capacity, and continues to modernize the PLA. The problem for a China looking to expand military and strategic influence is that her options are severely limited at present.

They are hemmed in by US military positions and alliances as mention. China faces pro-independence movements in Taiwan, Tibet and East Turkistan, with Taiwan the most serious and formidable. Moreover, China is heavily dependent on imported oil and gas and can ill afford to damage relations with supplier countries or countries that can disrupt the importation of energy to them. It is therefore not surprising that China has to talk the language of peace whether or not they would want to.

HOW AMERICA WANTS TO CHECK CHINA'S EXPANSION



Source: Eurasian Review of Geopolitics

Moreover, to become the great power in Asia which China periodically admits to coveting, they have to displace the US from its political and military presence in the West Pacific and ultimately push the US out of any Asian security system. However, there is no evidence that US allies Japan, South Korea, Taiwan, and Philippines are showing any signs of weakening. Indeed, each time alliances with these countries are reaffirmed and military coordination strengthened, the Chinese display noticeable signs of consternation, paranoia and displeasure. Moreover, the US has strengthened security ties with Pakistan, Afghanistan, Singapore and Thailand, improved relationships with Malaysia, Indonesia and Vietnam and is building a strategic relationship with India. China meanwhile has played an ineffective 'spoiler' role in subtly trying to foment sore points between the US and these countries. In other words, China is not building as much credibility and legitimacy as alternative regional leader as they would like.

Conclusion

Nothing of what we have said above changes our mind that strategic competition between the US and China will be the defining issue for the next generation (with Australia caught in the middle.) The point of looking at the key domestic and international challenges for a 'China growing strong' is that how China responds will determine what kind of global power they become.

The West is in a conundrum about what to do about China. A China that is too strong will challenge the status quo and cause instability. But a China too weak might be even worse: a failing state with great power ambitions, over a billion people with a strong sense of nationalism, and nuclear and formidable military capacity is not the kind of player any one would want in the system.