



## **China: Think Again!** by Harry Harding

A lot of the analysis we read about China is exaggerated or, at worst, misguided. Consider the following pieces of conventional wisdom about China's future:

### *China's Biggest Risks are Economic*

No. In fact, China's most severe risks are ecological – particularly its environmental problems and its vulnerability to communicable disease. This is not to say that China has no economic problems. No country is immune from the normal business cycle, and China today is subject to both inflationary and recessionary risks. But Beijing is developing the fiscal and monetary tools to prevent these problems from becoming catastrophic.

In contrast, China's ecological and health risks are far more serious than people realize. Air pollution in China is affecting the quality of life in cities like Beijing, Hong Kong, and Shanghai, among others. The risk of water shortages, both in agricultural areas and major cities, is high and growing. The Chinese government is already warning that the country's emission of carbon dioxide and greenhouse gases will significantly damage China's agricultural production.

China is also experiencing epidemics of chronic disease. Reported cases of HIV increased by 30 percent to roughly 650,000 in 2006; the UN projects that 10 million Chinese will be infected by 2010. Hepatitis infects 10 percent of the population. The probability of an outbreak of an acute communicable disease like avian flu remains high. The main issue is how virulent the virus will be, and whether its spread can be contained. The risk is exacerbated by the decay of the rural public health system.

### *A Second Tiananmen Crisis is Inevitable*

Hardly. The Tiananmen Square crisis of 1989 involved mass protests in scores of cities across China – and the demonstrations in Beijing were so large that the government was able to suppress them only through the use of brutal military force. Though not inconceivable, another dramatic uprising on that scale is unlikely.

It is true, however, that China has many problems that are producing widespread popular discontent. Beijing reported some 80,000 incidents in 2005, some quite large and even violent. But Chinese leaders are adopting policies to address the causes of rural grievance. When protests do occur, they arrest the leaders but often try to remedy the issues that caused the unrest. Above all, by controlling the media and suppressing independent political organization, Beijing is trying to ensure that protests remain localized.

The real concern is whether bigger issues could foil these efforts. The emergence of serious and widespread economic problems (especially inflation and unemployment) or the

government being blamed for a major domestic or international crisis could lead to nationwide discontent, particularly if the dissatisfaction were so widespread that it overwhelmed the party's control over the media or produced a divided leadership. In such a circumstance, there could be large-scale protests in several major cities that might be difficult to control.

### *Chinese Elite Politics are Stable*

Yes, but less than you might think. Chinese politics has become increasingly institutionalized, the elite are more pragmatic, and top leaders want to avoid a perception of internecine feuding. But President Hu Jintao has had to tread more softly than his predecessors.

Hu is nearing the end of his first five-year term. Past practice suggests that one or two potential successors should have been appointed to the Politburo by now. Hu will have to identify his heirs apparent by the 17<sup>th</sup> Communist Party Congress this fall so they have enough time to win broader support before Hu retires in 2012. If his choices are not widely accepted, the party's legitimacy could decline.

What is even more worrying is that the gridlocked succession may reflect a lack of agreement on China's policy decisions. True, Hu recently secured formal endorsement of his stance that China needs to address its most serious domestic problems and spread the benefits of economic growth in order to tamp down social conflict. But that doesn't preclude a debate over how to achieve that goal.

### *China's Banks will Collapse*

Doubtful. Until very recently, China's banking system was in big trouble. It was the main mechanism for financing the country's high levels of investment, which made up 45 percent of gross domestic product (GDP) in 2005. The banks faced considerable pressure to lend money to inefficient state-owned enterprises. As a result, the volume of the country's nonperforming loans rose to alarming levels. But the banks survived, largely because depositors had few other outlets for their savings. The banking system was not that solvent, but it remained liquid.

In recent years, China's corporate sector has become a less risky bank customer. Investment is increasingly being financed by means other than bank loans, such as bond issues, corporate profits, or stock offerings. And a gradual process of mergers, acquisitions, and privatization is increasing the profitability of formerly state-owned enterprises. At the same time, the bank solvency has also improved.

China's financial system isn't entirely out of the woods. The banks' lending decisions are still subject to political pressures; the party still chooses senior bank executives from its ranks. The health of smaller local banks, investment brokerages, and insurance companies is not ideal. And with a

growing range of investment opportunities – including the stock market, real estate, and even foreign mutual funds – Chinese banks now have to worry that financial insolvency could more easily generate liquidity problems. Even so, China's low level of foreign indebtedness gives it the tools to contain the economic consequences of a financial crisis.

#### *China is Too Dependent on Foreign Money*

Not really. China is certainly highly integrated into today's international economy. By abandoning the economic autarchy of the Maoist period, it has become a major trading nation. It exports large volumes of textiles, machinery, and electronic equipment. In turn, it imports advanced technology, petroleum, and other natural resources. It is also a favored destination for foreign direct investment (FDI), due to its attractiveness as a manufacturing platform for exports, and because of the size and dynamism of its own domestic market. China now attracts twice the FDI it did 10 years ago.

The relatively large ratio of exports to China's GDP and the volumes of incoming FDI have generated concern that China is too dependent on the international economy and is acutely vulnerable to a slowdown. But, with \$1 trillion in foreign exchange reserves, and an extraordinarily high domestic savings rate (47 percent), China is hardly dependent on foreign capital. It has relied on the technology and marketing networks that accompany foreign investment to promote its exports, but would likely survive a reduction in new investment.

The same is true with trade. China is a large continental economy, and at 64 percent of GDP, its trade dependence is far lower than Hong Kong or Singapore. Moreover, much of the value of Chinese exports is provided by imported components and raw materials, with local elements providing relatively less value. Sure, China would take a hit if there were a global recession or a terrorist attack that crippled international trade flows. But its economy could weather that challenge better than most.

#### *Chinese Nationalism is on the Rise*

Yes, but don't exaggerate its implications. Popular nationalism has been a part of China's fabric since the middle of the 19th century. It emerged as a reaction to invasion by more technologically advanced nations – first from Europe, then Japan. More recently, the Chinese Communist Party has been encouraging nationalism as a source of legitimacy. But the party recognizes that nationalism is a double-edged sword. Although it can be a source of domestic legitimacy, it can also generate apprehension and mistrust abroad. That lesson was borne out by several anti-foreign protests, including those against the United States for the accidental bombing of the Chinese Embassy in Belgrade in 1999 and for the collision between a U.S. reconnaissance aircraft and a Chinese fighter in 2001. Although these episodes did no lasting damage to Sino-U.S. relations, Beijing was alarmed by the fervor of the protests and the time it took to bring them to an end. China's leaders understand that nationalism can generate public criticism of leaders who "capitulate" to foreign governments just as easily as it generates support for those who are perceived as upholding Chinese interests. Accordingly, the promotion of nationalism now plays a smaller role in the party's search for legitimacy.

Popular nationalism can have its own momentum, independent of the wishes of the party's leadership. But without further democratization, nationalistic public opinion isn't powerful enough to determine Chinese foreign policy. It could, however, be a source of political instability if the Chinese government were accused of failing to uphold the national interest in the event of an international crisis.

#### *China's Rise will Lead to Military Conflict*

Highly unlikely, at least for the foreseeable future. Yes, China is modernizing its military, seeking not only a stronger nuclear deterrent but also a greater ability to project conventional force. And like any powerful country, China will use force if it believes its vital national interests are at stake.

But China is no longer a revolutionary power. It does not have fundamental complaints about the international economic and political systems from which it has benefited over the past 25 years. Moreover, its economic interdependence with the rest of the world will deter Beijing from military adventures unless core interests are threatened. The rise of Chinese power, in turn, will deter China's neighbors from threatening its core interests. Beijing has drawn its red line in the Taiwan Strait so narrowly – a *de jure* declaration of independence by Taiwan – that it is unlikely ever to be crossed.

#### *Conclusion*

The real challenges from China are, therefore, far more subtle than alarmists would suggest. First, though China is willing to join the existing international order, it wants to play a larger role – as a rule-maker, not just a rule-taker. Fortunately, Washington's current policy of encouraging China to become a "responsible stakeholder" is largely compatible with Beijing's desire for greater influence.

A second challenge stems from the desire that Chinese firms gain the greatest market share domestically and join the ranks of large, profitable multinationals. China is a poster child for globalization, but Beijing's objective is to see that Chinese firms are the winners of that global competition. Indeed, economic nationalism may pose a greater challenge than any other form of Chinese power.

China is simultaneously rising on several dimensions – military, economic, diplomatic, ideological, and cultural. In that regard, it more closely resembles the United States of the 1950s than, say, 1930s Japan or Stalinist Russia. The greatest risk is not that Beijing will use its military power to attack other countries, but rather that it will use its growing resources to shift the overall balance of power in China's favor, especially in Asia. It is a strategic shift that has already begun.

*Harry Harding is chair of the China Task Force at the Eurasia Group in New York. Reproduced in abridged form with permission from FOREIGN POLICY # 159 (March/April 2007) [www.foreignpolicy.com](http://www.foreignpolicy.com). © 2007, Carnegie Endowment for International Peace.*