The 2011 Lowy Lecture on Australia in the World

Lionel Barber

Editor, Financial Times

LOWY INSTITUTE
FOR INTERNATIONAL POLICY

The annual Lowy Lecture is the Lowy Institute's keynote event, in which a prominent thinker reflects on the global influences shaping Australia and the world. The lecture supports our mission to generate fresh ideas and dialogue within Australia on international developments and to contribute to the wider international debate as an accessible and high-quality forum for discussion of Australian foreign policy and international relations.

The shift of global economic and strategic weight from West to East is a change of world-historical significance with particular implications for Australia. It has provided the focus of the Lowy Institute's major research themes for 2011.

The 2011 Lowy Lecture examines the implications of Asia's rise for the world and offers some prescriptions for accommodating the rising Asian powers in a new economic order for the 21st century. It was delivered by the editor of highly respected newspaper the *Financial Times*, Mr Lionel Barber.

In his lecture, Lionel Barber focuses on China's phenomenal growth and how its aspirations as the 'superpower in waiting' might be accommodated without conflict. He argues that all interested parties have a mutual interest in upholding and developing – rather than overturning – the rules-based system built up after World War II.

While the West, principally the US, will have to adjust to accommodate China, Barber argues that China will also have to accommodate, notably in the fields of finance, money, trade and direct investment and energy. China's great test is to achieve a balance between rapid development at home and stability abroad. Australia – and the rest of the world – has a huge stake in the outcome.

Lionel Barber has been the editor of the *Financial Times* since November 2005. Since then the FT has won numerous global awards for quality journalism, including three newspaper of the year awards, which recognised the FT's role 'as a 21st century news organisation'.

As editor, Barber has interviewed many of the world's leaders in business and politics including: President Barack Obama, Premier Wen Jiabao of China, President-elect Demetri Medvedev of Russia, Chancellor Angela Merkel of Germany, and President Thabo Mbeki of South Africa.

In 2001 European Voice named him one of the 50 most influential personalities in Europe. Barber has co-written several books and has lectured widely on US foreign policy, transatlantic relations, European security and monetary union in the US and Europe.

The nature of power, and how it is being redistributed in Asia and the world, are the defining questions of our age. With the 2011 Lowy Lecture, Lionel Barber challenges us to think harder and deeper about these questions, and how they will test a Western country located on the edge of a rapidly changing Asia.

Michael Wesley
Executive Director

ASIA'S RISE, THE WEST'S FALL?

Lionel Barber

Editor, *Financial Times*

Sydney, 17 November 2011

Distinguished guests, ladies and gentlemen, it is a great honour to deliver this year's Lowy Lecture. This is my first visit to Australia. As an Englishman with an Irish grandfather who long dreamt of escaping Down Under, that's an embarrassing admission. A bit like the skipper being out for a golden duck. But I have already found so much to admire: the majestic architecture here in Sydney, the sulphur-crested cockatoos of Katoomba and the mystical beauty of Uluru. Truly this is the Lucky Country.

Donald Horne's barbed tribute has a special resonance today. Resource-rich Australia is enjoying the fruits of an extraordinary regional economic boom. Luck plays a little part in this chains to riches story. But you are also reaping the rewards of politically courageous decisions to curb public deficits and inflation more than a decade ago.

Australia's good fortune is also to be part of an historic shift from West to East, driven largely by the rise of the once-poor countries of China and India. This shift in power, primarily economic power, has aroused much soul-searching in Europe and the US; even talk of an Asian century. Hence the mildly provocative title for my lecture tonight.

Only last month, Jean-Claude Trichet, president of the European Central Bank, told the Financial Times in a farewell interview that there was a crisis in the West, in terms of business models and political decision-making. Admiral Mike Mullen, former chairman of the Joint Chiefs of Staff, said earlier this year that the national debt posed the greatest threat to America's national security.*

The global financial crisis must bear much of the blame. It was manufactured in the West and exported to the rest of the world, wreaking havoc with the public finances of the US and much of Europe. Standard & Poor's decision this summer to strip the US of its triple A credit rating appeared to confirm the superpower's steady slippage. Financial markets have challenged the creditworthiness not merely of Greece, Ireland, Portugal and Spain – but also, crucially, Italy and the AAA status of France.

Western leaders have failed to respond decisively. In early 2009, the newly formed Group of 20 countries did agree to recapitalise their banks and collectively pursue aggressive fiscal stimulus to revive their economies. But too often, they have been offered too little, too late. Western governments have either been held hostage

by powerful interest groups or paralysed by ideological divisions.

This is particularly true in the US. Democrats have adopted the language of European class warfare while Republicans – cowed by the Tea Party – are dedicated to the proposition of no new taxes under any circumstances. Not even what Ronald Reagan euphemistically used to call revenue enhancers.

The paralysis of the West contrasts with activist leadership in the East, India being perhaps the exception. China, for example, has taken bold steps, first in 2008/9, to stimulate its economy. Beijing has followed with an ambitious five-year plan to transform the economy from export-dependent, investment-led growth to a model more conducive to bolstering wages and domestic consumer demand.

So will illiberal or authoritarian capitalism, at least in the short term, prove more effective than a deadlocked democratic system of checks and balances as practised in the US – or indeed the makeshift efforts to resolve the euro crisis among a group of 27 nation states? Europe's questionable decision to pass round the begging bowl in Beijing offers a symbolic answer.

Francis Fukuyama, champion of liberal democracy who is best known for his book *The End of History and The Last Man*, published at the end of the Cold War, seems to share the doubts: 'In many ways, Asian government, not just China, but Singapore and in an earlier day, Japan and South Korea, had governments that looked more like a corporate board of governance…You run the whole country like a corporation, and I think that is one of their advantages at the moment.'*

Professor Fukuyama's corporatist model may not take sufficient account of democratic stirrings in, say, Singapore. But his point is well taken. Still, I would like tonight to tackle the proposition head-on: Is the West presently severely disadvantaged with regard to Asia, if not in relative decline? I also want to take a harder look at the sustainability of the Chinese model of authoritarian capitalism. Finally, I would like to issue a friendly warning: if present trends prove durable, we are in the middle of an historic transition. And such transitions usually carry risks. Without accommodation, there is the risk of conflict, either through protectionism or, in the last resort, war. What can be done to prevent such a negative outcome?

The rise and descent of the West

By historical standards, the supremacy of the West is a relatively recent phenomenon; it may prove relatively short-lived too. Professor Ian Morris of Stanford has identified two poles of civilisation: the

West, the civilisations that descended from the agricultural revolution in the so-called fertile crescent in today's Middle East, and the 'East', the civilisations that emerged from an independent revolution in a part of what is now China. Until the fall of the Western Roman Empire, the West was slightly ahead. It subsequently fell behind until the 18th century when it edged ahead. Now (even allowing for vagaries of state-sponsored statistics,) the West looks once more to be lagging.*

For the first three quarters of the nineteenth century, it was Britain that appeared as a colossus astride the world. Charles Darwin, visiting the thriving port of Sydney, wrote in January, 1836: 'My first feeling was to congratulate myself that I was born an Englishman'. Darwin contrasted Sydney's bustling prosperity with the sedate former Spanish and Portuguese colonies which he had just visited. These colonies, he concluded, had barely advanced over the past 300 years.*

Britain's ascendancy was based on the native inventiveness of its people, the linked growth of manufacturing industry and naval supremacy which guaranteed access to markets and made the country's military a force to be reckoned with. In the same vein, the rise of America as an imperial power may be traced back to February 1909 with the return of the Great White Fleet, the sixteen first-class battleships that President Theodore Roosevelt had dispatched on a 45,000 mile cruise around the world as a show of American power.*

America's intervention in two world wars – supported by the Australian Imperial Force – rescued Europe from the demons of nationalism and fascism. The US was also present at the creation of a new world order after 1945 based on liberal democracy, political reconciliation between France and Germany, and a new rules-based international system for diplomatic, monetary and trade affairs. This system was anchored by new institutions such as the International Monetary Fund, the World Bank, the General Agreement of Trade and Tariffs and the United Nations.

The make-up of these new institutions naturally reflected the preponderance of US power. To the victors of World War II went the spoils: the allocation to Britain, France, the US, the Soviet Union and China of permanent veto-wielding seats in the United Nations Security Council; and a cosy carve-up between the Europe and US of the top jobs at the IMF and the World Bank respectively.

Today, the post-World War II settlement is manifestly anachronistic. It no longer reflects the balance of economic power in the world. Europe, for example, is grossly over-represented. That does not mean

that Britain or France will relinquish anytime soon their status as members of the Perm Five at the UN; but the economic (as opposed to the political) imbalance has at least been partially recognised by a reweighting of voting power at the IMF as well as the creation of new international forums.

The most notable of course is the Group of Twenty which brings in the rising powers of Brazil as well as important regional players such as Indonesia, Mexico, Saudi Arabia, South Africa, Turkey, and, yes, Australia. This adjustment is long overdue. While the G20 remains a fledgling body, it has the potential to enhance its legitimacy and strengthen its capacity as a new institution of global governance. The pressing question for the West is how to maintain influence and power in an international system where power is ebbing to new players. This question is particularly acute for Europe.

Europe and the euro: the doctor's dilemma

It was Charles de Gaulle who once remarked of La France: How can you govern a country with 246 varieties of cheese? Imagine how much harder it is to govern a Union of 27 different countries, many more types of cheeses, and a monetary union with fundamental flaws.

Let's quickly deal with the economics. Operating a centralised monetary policy with residual national budgetary and economic policies has proven impossible. German policymakers suffer from a 'quasi-religious belief' that only fiscal deficits matter. In fact, external deficits have been shown to be a far more reliable guide to indiscipline because residents have been spending more than their income and borrowing the rest from abroad. When credit was cheap – Greece, for example, could borrow on near equal terms to Germany – reality was suspended.

Europe's leaders have failed to convince financial markets that they can contain the crisis. After the last G20 meeting, an historic opportunity may have been missed. At best, Greece has bought time before the next aid package or a hard default. Europe's rescue find – the EFSF – has admitted it cannot raise the promised funds through extra leverage. The severe problems of adjustment for uncompetitive economies such as Greece and Portugal remain. The banking system remains fragile. Economic growth is lacking. And the one institution which is capable of providing a credible backstop – the European Central Bank – cannot do so for political reasons.

Here we come to the politics. At one level, it is possible to sympathise with Germany. The most powerful economy

in Europe gave up the D-Mark and joined a monetary union where several other members were unwilling or incapable of staying the course. But Chancellor Angela Merkel's first instinct has been to treat all debtor countries as sinners deserving Lutheran retribution before salvation through good works. Yet the surplus countries stand to lose far more if monetary union fails than in a bail-out of Greece.

When President Sarkozy is not lecturing the British about their semi-detached status in Europe, he is fixated about losing the triple A credit rating which could cost him next year's election. But at least he is capable of recognising political constraints in France and Germany. As he told Chancellor Merkel recently: 'Vous avez un parlement très fort mais un peuple très faible; et moi, j'ai un parlement très faible, mais un peuple très fort'.

In the space of a fortnight, the euro crisis has now claimed the scalps of two prime ministers – George Papendreou in Greece and Silvio Berlusconi in Italy – each replaced by technocrats. The appalled Franco-German reaction to Mr Papandreou's proposed referendum on the austerity measures underlines how democracy has been shunted aside, laying bear the broader crisis in popular legitimacy. Monetary union – at least in southern Europe – is too important to be kept to the elected politicians!

The EU faces an existential choice. Either it continues to muddle along in a loose arrangement which suits national sensitivities – a free-trade zone plus, if you like – or it moves toward tighter integration, if necessary through the formalisation of a two-speed Europe in which an advance guard of countries led by France and Germany takes shape.

Europe has agreed to such arrangements in the past. Think of the Schengen arrangement allowing the free movement of EU citizens and common visa policies. Think of the opt-outs which Britain has in this area and on monetary union. Significantly, the coalition government under David Cameron has also signalled that it is willing to countenance tighter integration among a continental core, on condition that the rights of Britain and other 'outs' are protected.

My guess is that the euro will just about survive, but a new system of economic governance will have to be introduced to keep the monetary union intact. Membership may not be the same in three years' time, or even less given the Greek crisis. If Italy were to default, the game would be up. But the euro focus does not begin to answer the real challenges facing a continent which suffers from an ageing population, low growth, hostility

to immigration and, with some notable exceptions, is lagging in innovation.

When I raise this on my visits to Berlin, Brussels or Paris, I am given a three-word riposte: the Lisbon agenda. Remember Lisbon, the agreement in 2000 to make Europe the most competitive knowledge economy in the world by 2020? In retrospect, Lisbon looks like an airy pledge made at the height of the dot com bubble.

The burden of regulation in areas such as the environment and employment law has grown rather than been reversed. And while the sovereign debt crisis has forced countries such as Spain to dismantle labour market barriers, others cling to a model protecting insiders rather than young unemployed in search of a job. Yet without action, rewriting Europe's generous social contract – and achieving decent growth rates – Europe is condemned to lose further ground to Asia and the US.

America the Ungovernable

In their new book, *That Used to be Us: How America fell behind in the world and how we can come back*, Thomas Friedman and Michael Mandelbaum write that Americans are 'getting only 50 per cent of potential benefits from our first-rate system', whereas 'China is getting 90 per cent of potential benefits from its second-rate political system.'*

While the diagnosis (and the book title) may sound glib, Friedman and Mandelbaum have put their finger on the institutional paralysis currently gripping America. This paralysis makes it doubly difficult to tackle long-term economic weaknesses long obscured during the near two decades of US hegemony after the end of the Cold War.

The Unipolar Moment, to use Charles Krauthammer's term, flattered to deceive in two other important ways. It encouraged the military adventurism of President George W. Bush, and it fostered the notion that the free-trade, deregulation-based American economic model, underpinned by fiscal discipline and easy monetary policy, was for export to the rest of the world.

It now turns out that America was selling flawed goods. Financial engineering combined with cheap credit almost brought down the world's banking system. We have come to understand that – sky-high remuneration levels aside – the financial services industry is similar to nuclear power: an essential utility but one which requires close supervision. Nor has the American model responded well to the structural challenges facing its economy.

First, globalisation has put virtually every American job under pressure. Second, the information revolution has eliminated vast swathes of what were

once deemed to be safe American jobs. (It also requires a far higher level of education than was once necessary to secure a job.) Third, the level of national debt and deficits crimp America's freedom of manoeuvre and impose an increasing burden on future generations.

Declining income and rising inequality have been most acutely felt among the 70 per cent of Americans who deem themselves to be middle class. And as a seminal MIT study has made clear, income stagnation and political polarisation are tightly correlated.* The rise of the Tea Party – the anti-tax, anti-government activists – is not only a visceral response to Federal government activism to tackle the Great Recession; it also reflects the genuine pain of a squeezed middle-class America.

Political polarisation has exacerbated the paralysis in Washington, highlighting the weakness of a system biased toward inaction. Yet the scale of the crisis calls for action, not today's stasis. In earlier times, a decisive president – Roosevelt, Truman and Reagan come to mind – has galvanised the legislature by invoking a sense of crisis and capturing the public mood. President Obama, for all his rhetorical skills, has not managed to do so.

Tom Friedman has fantasised about having a dictator for a day to get things done. Well, dictators have a habit of sticking around. Whatever the conventional east coast wisdom may say, the current paralysis does not necessarily spell a crisis of American governance. It is more tactical than structural. Let me explain.

In 2009, the White House understood that after the fall of Lehman, America faced the most severe financial crisis since the 1930s. The resulting economic downturn would be severe, but few predicted the financial repression, prolonged credit squeeze and its impact on the broader economy forecast by the likes of Professor Carmen Reinhart. Indeed, the best White House predictions were of a V-shaped recovery, a sharp rebound with jobs to follow. In this scenario, it made sense to take out an insurance policy on recovery through an economic stimulus but instead the main focus was a once-in-a-generation reform of health care.

The reform redeemed one of President Obama's main campaign pledges but it was pushed through Congress on partisan lines, akin to a three-line parliamentary whip. There was no serious effort to reach across the aisle. Republicans may not have wished to embrace a reform many dismissed as socialised medicine; but the White House and House Democrats have paid a heavy price for their partisan approach. Bill Clinton's adage about the primacy of the economy was ignored. The

resulting stand-off, exacerbated now by the 2012 election campaign, means that pressing long-term issues such as social security and other entitlements are off the table. Washington might as well have shut down.

The paralysis has some echoes of the 1970s after Watergate, though this was broken by the election of Ronald Reagan who, for all his avowed conservatism, showed time and again he could strike bipartisan deals ranging from tax reform to his broader supply side agenda. It would be short-sighted to rule out another strong executive leader breaking the Washington stalemate. Future Presidents should be under no illusion: action is required.

In their report *Rising Above the Gathering Storm*, produced jointly by the National Academy of Sciences, the National Academy of Engineering, the Institute of Medicine and Members of the National Research Council,* the authors identify the immediate threat to American pre-eminence: in a world where advanced knowledge is widespread and low-cost labour readily available, US advantages in the marketplace and in science and technology are under threat. The authors call for an immediate effort to raise education standards in high school, boost investment in basic research and ensure the US is the best place for top students, engineers and scientists in the world.

John Doerr, one of the foremost venture capitalists in America, was once asked to grade America in terms of research and development. He gave an A for information technology, a B/C for biotech (given regulatory hostility) and a C/D minus for energy innovation in areas such as solar. As Doerr remarked: Americans spend more on potato chips than on energy technology research.

Influential Americans are becoming increasingly concerned that the US is falling behind on innovation. In political terms, this can translate into the commonly held view that the US is no longer operating on a level playing field. Authoritarian capitalism in countries such as China holds an unfair advantage through tools such as a manipulated exchange rate. Remember: Americans love competition – as long as they are winning.

So far economic hostilities have been contained, though Congress is examining trade reprisals because of China's artificially low exchange rate. It would be tempting to seek to use the strategic competition posed by China to mobilise public opinion against an external threat. This happened first with the Soviet threat in the late 1940s and, less justifiably, with Japan in the 1980s. The question worth asking at this point, however, is how sustainable is the Chinese model itself?

China: the paradox of power

Chairman Mao famously exhorted people to focus on contradictions because every contradiction conceals a truth.* The problem in China today is that there are so many contradictions it is hard to know where to start looking. The country is a blur of social, historical, economic, geographical and political incongruities, most of which either derive from or are related to a single, overarching paradox: China is three decades into running a diverse capitalist economy with a single-party hierarchy.

So far, of course, the model of state capitalism has been wildly successful. But strains and stresses in the system are proliferating. Now, more than perhaps at any time since the era of 'reform and opening' began in late 1978, it is pertinent to ask whether China can continue to forge ahead with its current economic and political model.

Before examining these contradictions, it is worth reciting a few facts. China is already the second largest economy. It has the world's largest current account surplus and the biggest holding of foreign currency reserves, at close to $3.2 trillion. It is the world's largest exporter (if the European Union is counted as a set of 27 separate countries) and the second largest importer, (after the US), especially of raw materials and energy.

In a provocative book published this year, Arvind Subramanian, a former IMF economist, highlights the speed of China's ascent as an economic superpower. Assuming a (conservative) Chinese annual growth rate seven per cent and an (optimistic) US annual growth rate of 3.5 per cent, as well as a debt-induced growth crisis on the mainland, China's GDP would still be one quarter higher than America's by 2030 and it would have twice America's share of world trade.*

And yet, China's gross domestic product per head, at purchasing power parity, is still only about a fifth that of the US. This was Japan's relative position in 1950, before more than two decades of extremely rapid growth. As my colleague Martin Wolf has pointed out: China is set to become an economic superpower, while still a developing country.* It is, to coin a phrase, the premature superpower.

This is the essential background to Beijing's latest Five Year Plan which recognises that the investment-driven, export-led model that has delivered spectacular growth is less and less sustainable. Fixed asset investment now contributes more than 50 per cent of GDP growth, but the efficiency of that investment is declining rapidly. Nowhere is this clearer than within the crumbling

transport empire administered by the Ministry of Railways.

In the last five years, the Ministry's total debt jumped by 227 per cent to more than Rmb 2,000bn at the end of the first half of this year. But revenue over the same period rose by a mere 62 per cent. The result is an insolvency so pronounced that even those stalwarts of Chinese state capitalism – the 'big four' state banks – are starting to refuse to lend to the state-owned railway construction companies. Tensions between state enterprises and private enterprises in China are not new; but they are more potent than ever.

Rail is not the only sector in which huge debts are threatening long-term sustainability. Many road toll expressways, which were energetically built in 2009–2010 as local governments answered Beijing's call to stimulate growth, are also generating insufficient cash to service their the interest on the loans used to construct them. Only one out of all China's provinces makes a net profit on its toll roads; the rest are running up red ink. A similar situation exists in the real estate sector, with several developers failing to generate enough income to service debts.

These stark infrastructure problems do not mean the Chinese edifice is about to come tumbling down – Beijing still has plentiful fiscal resources and capital markets to tap. But they do mean that the current investment-heavy model is nearing the end of its line. There is a need – again, as the Five Year Plan says – to boost consumer spending and develop the service sector. But this is much easier said than done. Japan still has to achieve this, 30 years after declaring it a national priority.

The first impediment is that much of China's success has been built upon the involuntary sacrifices of the consumer. State banks have kept interest rates artificially low, penalising savers in order to preserve minimal borrowing costs for corporations. If this trade-off is now reversed, then the big state-run companies – which form the bulwark of the Communist party's economic power – would suddenly be disadvantaged.

In other words, while it is easy to see the rationale behind moving to a more consumer-centric economy, pushing through such reforms against the interests of a phalanx of corporate power brokers – many of whom hold the rank of minister or vice-minister within the party system – would be infinitely more difficult.

Other aspects of the state capitalist system are also showing the strain. China keeps electricity prices artificially low by mandating a state price for 'thermal' coal. But coal miners chafe at having to sell their produce to power stations at far

below the prices they would get by selling it on the free market. Every summer, when air conditioners are turned up across the country, the coal mines restrict supply of thermal coal just when power stations need it most. Sudden power cuts introduce people – in a palpable sense – to the heat produced by China's systemic contradictions.

Another cornerstone of the model is also crumbling. After 30 years of abundant cheap labour, there is now an absolute shortage of migrant workers in the big factory towns along the east and south coasts. Migrant worker wages have climbed by around 30 per cent this year compared to last, meaning that many low-tech manufacturers have had to relocate to cheaper production bases in inland China or move overseas. With the boom in rural China reinforcing a growing reluctance among rural workers to migrate, the trend of rising manufacturing costs is likely to continue, hitting China's competitiveness – though the response will be to move up the value chain.

As China embarks on the convulsive shift from low-cost manufacturing champion to a more consumer-friendly economy, the impact will be felt well beyond China's borders. The most obvious impact will be via the outward reach of China Inc. Propelled by waning competitiveness at home, China's manufacturers are scouring the world searching for markets, acquiring companies, upgrading technology and building brands.

The era of Chinese offshoring is upon us, and is likely to last for several decades. As Gerard Lyons, chief economist of Standard Chartered Bank has observed: the sense that everything is 'Made in China' may give way to a perception that everywhere is 'Owned by China' – though of course that may take a good while.

Seminal moments have already taken place. In the first quarter of this year, for the first time, Chinese companies did more M&A deals in the manufacturing, distribution and retail sectors than they did in the resource and energy sectors, the former mainstay of the country's outward push. The size of outward investment is also growing, and it is possible that this year, or maybe next, Chinese companies will invest more overseas than foreign companies invest in China.

The key destinations are already coming into focus: Brazil, Indonesia, Vietnam, Mexico, South Africa and even the United States. What distinguishes China's internationalisation from, say, that of Japan is the speed and scale of change. In the case of Brazil, Chinese trade used to account for just 2 per cent of trade a decade ago but now accounts for 16 per cent, overtaking the US.

China's commercial integration with the 10 member nations of ASEAN is also accelerating, and it looks possible that the region will overtake the US as China's second largest trade partner as soon as next year.

Yet even as China's embrace of the world proliferates and deepens, questions persist not only about what type of power it will be but also about how much power Beijing actually wields at home.

This year a few unheralded spectacles have emerged. Chinese savers have withdrawn their money in droves from the big state banks – where the interest they earn falls woefully short of inflation – and deposited them in shadow banks, where they earn a real return. The haemorrhage has been so large that the shadow financial system – which exists beyond regulatory remit – now extends more credit every month than the official banks do. The loss of financial control is startling but it is matched in the sphere of media, another bulwark of Communist party power.

The rise of sina weibo – China's version of twitter – has punched a big hole in the party's propaganda control. Some 200 million Chinese citizens now air opinions on events at home and overseas real time, and the sheer volume of comments is so large that the censors can no longer keep up. When a tragic high speed train accident killed 41 people in July, a storm of anti-government criticism flew on weibo. Beijing was accused of covering up evidence at the crash site, rescuers were charged with callous indifference to the plight of victims.

Wen Jiabao, the premier who claimed that his late appearance at the scene was because he was ill in Beijing, was shown on weibo to have been attending meetings during the time he said he was ill. The authorities are now seeking to curb the activities of the bloggers, but it is unclear if they can regain decisive control over public opinion.

What we are witnessing, therefore, is the emergence of fundamental contradictions in the Chinese political-economic model. In the past, with the exception of Tiananmen Square, the Chinese elite have proved exceptionally adept in modifying their model without surrendering control of the levers of power. Their legitimacy has also rested on the mantra of delivering ever improving living standards.

All this creates considerable soul-searching among those in charge of China's body politic. Foremost among them is Premier Wen himself. Speaking at the World Economic Forum in the northeastern city of Dalian in September, he prefaced his remarks by saying: 'I feel a strong sense of responsibility to present my views on various issues in an accurate and candid manner.'

The man who once accompanied the former Communist party boss, Zhao Ziyang, onto Tiananmen Square in 1989 to plead with the student demonstrators to leave the square for their own safety, then set out a plan for political reform. He said China should:

1. Separate the functions of the party and the government in order to prevent over-concentration of power.
2. Create a truly independent judiciary to uphold justice.
3. Safeguard the people's right to know, elect, participate in and supervise the government.
4. Promote social justice through redistribution of income and create a social security system that covers unemployment, old age and medical care.
5. Fight corruption resolutely.

It is quite a to-do list. But it is far from certain that anyone will try to implement it. However, if they do not, the China that bestrides the world may remain a nation apart, starkly different in character from the capitalist democracies around it and riven by unreconciled domestic contradictions.

Conclusion

In this lecture, I have focussed on China to the exclusion of other important Asian countries, notably India and Japan. That is not because they are marginal – far from it. Indeed, the growth of China and India is already having a profound impact on trade patterns, in particular helping exporters of natural resources in Angola, Argentina, and Brazil and purchasers of labour-intensive products, above all in the West. But rising prosperity and expanded opportunity do not take into account the challenges of contested political power and the scramble for natural resources.

China's rise, when measured in terms of higher living standards for a long-suffering population, should draw admiration and respect. But it should not be a matter for euphoria. China's rise is likely to have far-reaching economic and geopolitical consequences which in turn require deft statesmanship.

Throughout the ages, the failure to accommodate rising powers, or rather the failure of rising powers to accommodate the existing state system, has been a source of conflict. Germany's search for a place in the sun at the end of the 19th century is one example; resource-hungry Japan's quest for a co-prosperity sphere in the interwar period is another. In the case of China, it is vital that all interested parties

grasp the mutual interest in upholding and developing – rather than overturning – the rules-based system built up after World War II.

Of course, the West, principally the US, will have to adjust to accommodate China. But China will have to accommodate too, in particular in the fields of finance, money, trade and direct investment and energy. In coming years, this will have to cover the liberalisation of the banking system, the outflow of official capital resulting from massive intervention to support the Yuan and ensuring sterilisation, and the future convertibility of the RMB (though that prospect is not immediate). It will also cover intellectual property and foreign direct investment.

In the same spirit, China has an interest in pursuing policies which are both consistent with protecting its own interests and the international order. It is troubling therefore to note the number of territorial disputes which China is involved with in the neighbourhood. These include spats with Japan, the Philippines and Vietnam as well as the protracted stand-off with India and Taiwan.

As Chinese power grows and its blue-water navy capability expands, and the search for security of supply for natural resources intensifies, the risks of tensions escalating are obvious. It cannot be stressed enough that China's interest is to preserve the stability which is the best guarantee that Beijing can continue to deliver the increasing levels of prosperity shared by its people.

If this is to be an Asian century, what does this mean for Australia? Well, to paraphrase former British foreign secretary Douglas Hurd, Australia does punch above its weight. You can call on longstanding cultural and familial ties with Britain and Europe; you work closely with the United States in economic and security matters; but you are also closely linked to the Asian region, especially China. You might even be characterised as the West's early warning system in Asia.

Australia is also an active player in the G20, bridging developing and developed countries. You can speak as an advocate of free trade but also as a critical supplier of natural resources. You have every right to be seen as a strong country committed to the region but also as an aspiring global player. Asia's rise should therefore be a source of encouragement, even if the West's present travails will cause trepidation.

History however rarely travels in straight lines. The rise and fall of nations is no exception. In the case of America, decline is at worst relative. Europe's problems are very serious, especially in terms of its aspirations to be a coherent international actor. The rise of China to economic and political superpower seems

assured. But this is not – and should not be – a zero sum game. China's great test is to achieve a balance between rapid development at home and stability abroad. Australia – and the rest of the world – has a huge stake in the outcome.

Acknowledgements

Admiral Mike Mullen speaking to the Hill breakfast club June 24, 2011 as reported in US media.

Francis Fukuyama, Lunch with the FT, May 28, 2011.

The Rise and Fall of the British Empire, Lawrence James, p 236, Abacus.

Why the West Rules – For Now, Professor Ian Morris, Profile Books, as cited in Martin Wolf, *Financial Times*, January 12, 2011.

First Great Triumph, Warren Zimmerman, Farrer Strauss Giroux.

That Used to be Us: How America fell behind and how we can come back, Thomas Friedman and Michael Mandelbaum, Farrer Strauss Giroux.

A cure for a sick country, Stanley Hoffman. *New York Review of Books*, November 9, 2011.

America in the Age of Descent, by Edward Luce, to be published in 2012.

Martin Wolf, China in the World Economy, delivered to a Beijing conference September 2011.

Martin Wolf, There is no sunlit future for the euro, *Financial Times*, October 18, 2011.

James Kynge, author of *China Shakes the World* and publisher of *China Confidential* – various comments.

31 Bligh Street Sydney NSW 2000
Tel: +61 2 8238 9000 Fax: +61 2 8238 9005
PO Box H-159 Australia Square NSW 1215
ABN 40 102 792 174
Twitter: @lowyinstitute
www.lowyinstitute.org

LOWY INSTITUTE
FOR INTERNATIONAL POLICY