

**CHINA AS A GREAT POWER:
SOME IMPLICATIONS FOR AUSTRALIA**

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The world, including that large part of the world which is China, is having some difficulty in getting its head around the idea that China has emerged as one of the two great powers.

It shouldn't really be so difficult, because for most of the past two and a quarter millennia China has been the great power. The first time most of today's China –what would once have been described as China Proper – came together within one State was in the Qin Dynasty, which roughly coincided with the early stages of the rise of Rome.

The height of the longer-lived and more cohesive Han Dynasty's power roughly coincided with the peak of the power of Rome. At that time there were two great powers in the world, of comparable extent, population and technological advancement.

The Roman Empire gradually disintegrated; never to be put together again. China disintegrated as a State from time to time, but each time was brought together again--in a short time in long historical terms – and a Chinese State resumed authority over the old territory.

For most of the time since the Qin Dynasty, China has been the biggest economy on earth, and for most of the time the strongest State on earth. China was the biggest economy and strongest State when George III sent Earl George Macartney as his envoy to the Emperor Qianlong in 1783 and suggested to him that there would be mutual advantage in close trade and diplomatic relations. Qianlong considered the matter. There had been a little awkwardness about Macartney's reluctance to kowtow. But when that was all over, the emperor didn't stand on his dignity. He gave his considered opinion: Britain didn't have anything that China needed.

We now all know that it would have been wise for the Chinese leadership to treat more respectfully the upstart power from the island off the western shore of the Eurasian continent. Just half a century later in 1840, the Chinese emperor sought to exercise authority over visiting British entrepreneurs by enforcing China's laws on trade in narcotics. The British House of Commons spent a long night debating how it would respond. Gladstone gave what Jenkins has described as his greatest speech to the Commons in the early hours of the morning, arguing that the defence of the narcotics trade was not a good use of Britain's rising power. It is said that Matheson and Jardine had bought much of the House. Gladstone persuaded many members, but not enough. The British Navy sank the Chinese fleet at Canton and made the Chinese coast safe for opium from India.

1840 was about the year when British economic power and strategic weight, growing out of the great scientific and technological and economic revolution that had gathered momentum in the late 18th century, first exceeded those of China.

The rise of Britain as a great power had not taken long. But China took a long time to adapt to the rising power of first Britain and then the west more generally. China was so confident in the superiority of its own political system and culture that, for a long

time, it did not feel challenged. In this, China was different from Japan, which was smaller, and more vulnerable.

Japanese absorbed lessons from that first Opium War about the vulnerability of China and of the old Sinitic East Asian world of which Japan was part. From 1840 there were influential groups in Japan favouring accommodation with the new ways of the West, and recognising that absorption of the new knowledge – the scientific revolution, the economic revolution, the industrial revolution – was going to be necessary for the preservation of Japanese sovereignty and elements of old Japanese ways.

In Japan, people around the Shogun began to move towards accommodation of the new ways of the West. That generated a great reaction, which led to the restoration of the power of the emperor, the Meiji Emperor. The Meiji restoration began as reaction against those who wanted to accommodate the new ways of the West but was quickly transformed, as the young emperor and those around him came to realise that there was no alternative to absorbing the knowledge of the West.

So the Meiji restoration, beginning as a reaction against the productive new ways, became a movement favouring quick absorption of those ways. This new orientation of Japan destabilised the power balance in the old Sinitic world.

Up until the early years of the Meiji Emperor, Japan held a respected but subordinate place in a Chinese world. The Japanese emperor would correspond to the Chinese emperor in classical Chinese. The awful Chinese term 'barbarian' would be used for people from the northern and western borders, and for the newcomers from the Atlantic, but not for Japanese.

Application of the new technology and other new ways from the West quickly changed Japan's position in East Asia and the world. From the 1890s, rising Japanese power challenged China. Still China had difficulty in coming to grips with the need to change.

The success of the communist revolution was accompanied by widespread acceptance within the society of the need for fundamental change. The Chinese Communist Party took what is now widely understood as a wrong turn; following the Soviet Union into central planning led to terrible failure. It took almost three decades for change in communist China to move onto its modern productive path. A couple of years after the death of Mao Zedong, in December 1978, Deng Xiaoping secured the numbers in the Central Committee of the Chinese Communist Party, and committed China to opening to the outside world and to market-oriented reform.

China has been on what in retrospect looks like an inexorable path of opening and reform since December 1978. There has been no period since then in which economic reforms and opening went backwards. There have been periods when internationally-oriented reform has moved forward faster. There was one period when the reforms were challenged: in late 1989 and 1990, leaders who felt uncomfortable about market-oriented reform used the West's reaction to the Tiananmen massacre to seek to turn policy back to older times. But the reaction against reform in 1989 and 1990 failed, and

was followed by a period from 1992 when the movement forward into internationalising the economy moved more rapidly than ever before.

The facts of Chinese reform and economic growth from December 1978 are now well known. Average economic growth in China since then has been almost 10 per cent per annum. Growth has been fastest in the last decade, in the early 21st century, when the average has been over 10 per cent.

When the economy of a country with a large population grows rapidly for a long period of time, it becomes a large economy. That is happening in China. China will be the world's largest economy when its people on average are about one quarter as economically productive as the people of the United States. Does anyone who has had much interaction with China think that the Chinese people for long would be on average less than a quarter as productive as people in the United States? So in the absence of major political instability, on a scale which would end rapid economic growth, then China is on a course soon to be again the world's largest economy. Instability on a scale that would disrupt this outcome is not impossible, but it is unlikely.

China's catching up with the average output and incomes of the world's most advanced economies from here, as measured conventionally in the national accounts, will proceed more rapidly than would be anticipated simply from extrapolating the respective expectations of rates of growth in China and the developed countries. China will catch up faster than all but the thoughtful and informed anticipate, because China is approaching what the Japanese economist, Minami, following the American economist Lewis, called the "turning point in economic development".

In the early stages of economic development in all of the East Asian economies, rapid export growth was based on more effective use of abundance of labour. Comparative advantage was in labour intensive goods. Rapid industrial growth was based on exports of relatively simple manufactures, using a lot of labour. This could keep going for a considerable while as labour came into the growing centres of economic activity from the countryside. The inflow of labour from the countryside kept wages relatively low, and for a considerable period maintained the competitiveness of simple, labour intensive manufactures.

Japan reached the turning point in economic development, at which there was no longer an abundance of 'surplus' labour in the countryside, in the early sixties. Korea and Taiwan reached that point about one and a half or two decades later.

China is at or approaching that point now. In recent years, rural and urban wages for relatively unskilled labour have started to increase rapidly. The Great Crash of 2008 stopped this process for a period that turned out to be brief. Real wages are again rising strongly, now more rapidly than ever.

The turning point in economic development is accompanied by profound structural change. Measured output and incomes in China will rise rapidly relative to developed countries, not only because growth in output is strong, but also because the labour content of non-traded goods and services will be valued more highly. China will lose

competitiveness in labour-intensive goods, and will move towards export of a wider range of technologically sophisticated and capital intensive goods and services. After a couple of decades of increasing profit share in national income, rising savings, and external payments and trade surpluses, the profit share, savings and trade surpluses will stabilize, then fall.

There is a lot of current talk of China's currency being undervalued, and of this being the cause of China's trade surpluses. The structural changes that I have described will take place over the next half dozen years whether or not China maintains a fixed exchange rate against the US dollar, or appreciates the Renminbi.

Maintaining the exchange rate regime that has been applied since The Great Crash of 2008 would not delay the adjustment much, nor change its character or its eventual extent.

The most important difference that the choice of exchange rate regime will make is on inflation in China. If China maintains a fixed exchange rate against the United States dollar, probably a relatively weak currency in the years ahead, inflation will accelerate, soon to uncomfortably high levels. The big structural adjustment will be forced by China's price and cost level in local currency rising more rapidly than the price and cost levels of other major countries. Renminbi appreciation would reduce domestic inflationary pressures, so that the adjustment would be shared between a rising currency, and rising domestic prices and costs—the more currency change, the less inflation.

There is a possibility that the onset of inflation at rates considered by the polity and the authorities to be unacceptably high would lead to attempts to control inflation by lowering the growth rate through the tightening of demand policies, and by the imposition of direct controls on prices. This would result in unnecessary loss of potential for higher living standards, and may be seriously destabilizing to the economy and perhaps the polity. It is unlikely to delay for long the rise in real wages and the associated structural adjustment.

There is no necessary reason for China's rate of economic growth to fall in the early years beyond the turning point in economic development. The savings rate will fall, but, in an economy which recently had a current account surplus—the surplus of savings over investment—of 10 percent, this may not lead to a reduction in the investment rate. Indeed, it is possible that the investment rate could rise even higher for a while, alongside a fall in the savings rate. The rate of total factor productivity growth, already high in recent years, may actually increase, as rising wages force greater focus on the efficient use of labour. The rate of growth of the labour force—in total, and in the more productive employment in urban areas-- will fall and then decline, but this is likely to be a small development in the economy as a whole.

China's growth rate is bound to come back towards and then to the developed country norm as its average productivity level rises to the global frontiers. That time is a couple of decades away.

China is already the world's second largest economy, a long way ahead of the third and closing rapidly on the first, in purchasing power terms. Within a few years it will be the second by a wide margin even when economic size is measured in terms of the national accounts converted into common currencies at market exchange rates. It is likely that China will be the world's largest economy by any measure within a decade. For a decade or two after that—until India's more favourable demography for growth in economic output begins to weigh heavily in the scales of history—the gap between China and Number Two will grow.

Sustained, rapid economic growth in China has been associated with a gradual shift in the global balance of economic weight for over three decades. The rate of change in the global economic balance has accelerated gradually as the relative size of China has increased. This has been associated with a gradual shift in the global strategic balance, because political weight is closely associated with economic size.

The gradual change gave way to sharp acceleration with The Great Crash of 2008. This story is told in the concluding chapters of my book with David Llewellyn-Smith, *The Great Crash of 2008* (Melbourne University Publishing, 2009). The Great Crash has left a legacy of serious weakness and lower growth potential in the United States, and even greater weakness in Europe. It has had little effect on the growth trajectories of the large Asian developing economies, first of all China and India, but also Indonesia.

One consequence is that the balance of global economic and strategic weight is shifting more rapidly than humans anywhere can think through the systemic consequences, and develop the new ways of managing relations between States that can be productive in a world so changed.

Global power is not shifting only towards China, which is unlikely ever to play the dominant role occupied by the United States over the past six or seven decades, let alone the two decades since the collapse of the Soviet Union. It is more likely that China will join the United States, a more deeply integrated Europe (beyond the current travails), and a rapidly growing India, as one of four great powers. This quadripolar world will for a time have a bi-polar core, with the United States and China having the central leadership roles.

This is the world in which Australians of the generations born after mine will have to make a large part of their lives. Whether we are talking about climate change policy, or nuclear proliferation and disarmament, or global financial stability, or the health of the international trading system, the position taken by the Chinese Government will be a decisive influence on global policy.

The emerging world will not work on any of the great issues facing humanity unless the two and the four great powers agree broadly on the directions of international cooperation. Chinese are not used to the idea that what they do has a huge influence

on the world system. The Indians are even further from thinking of their own actions being critically important to outcomes in the international system.

We all have a lot of thinking to do. Hopefully, the thinking will reach good enough conclusions early enough to avert some of the potentially catastrophic consequences of a failure of international cooperation.

As I noted earlier in my address, being a great power, even the great power, is not new for China. China will make the adjustment to China being a great power more rapidly than the rest of us. The history tells us to expect that China as a great power will have a capacity for insensitivity to the interests and perspectives of others, and to arrogance. In this, China is not distinguishable from other great powers in history. Middle powers and minor states have always had to live with that reality of power.

The necessary change in mind is greater for we Australians. The period of white settlement in this ancient continent roughly coincides with the period in which the English-speaking people dominated the seas and from about 1840 the world.

We are accustomed to feeling that the biggest boys or boy on the block is our close friend. That has led to habits of mind that now need some adjustment.

Our Prime Minister, Kevin Rudd, discussed some of the necessary changes in his Morrison Lecture in Canberra on 23 April. As the Prime Minister said, “we need to understand China more deeply and engage with China at all levels”. We have to embrace “Sinology that engages with the Sinosphere and a vibrant and energetic contemporary China—in all its dimensions”. That requires investment in knowledge and understanding, and a willingness to apply that knowledge in honest discourse with the one of the four great powers of the future that is resident in our own Western Pacific region.

As the Prime Minister said to us three weeks ago, that sometimes involves speaking our mind with clarity and honesty; of seeking to be zhengyou.

This involves departure from one old Australian style, of shouting whatever comes to mind, from around the trouser legs of a great and powerful friend. It requires drawing on another Australian tradition, of exercising a distinctive Australian objectivity in relations with others.

A productive relationship of the future requires Australians to speak from close understanding of how Chinese see the issues on which we seek influence, and of how we ourselves are seen and understood.

I will illustrate the challenge facing us by reference to two issues that have been prominent in the public debate over the past year: direct foreign investment, and climate change.

We think of ourselves as being open to direct foreign investment. Such investment, first of all from the United Kingdom and the United States, has been important to our development from the beginning of modern Australia. It is more important than ever

now, as the means of covering uniquely large current account deficits that is least vulnerable to financial crisis in a time of global financial fragility.

We developed our relatively open approaches to direct foreign investment when the large, English-speaking economies were the world's main source of surplus savings for international investment, and of direct foreign investment.

Through the early twenty first century, the Asian economies in general and China in particular became the main sources of surplus savings for international investment. Through the global financial crisis, China became a much larger source of direct foreign investment, at the same time as direct foreign investment from the United States and Western Europe shrivelled to a fraction of its former level.

In the new circumstances, openness to foreign investment meant openness to Asian and to Chinese investment. Our society and polity ceased to be certain that it wanted to be open to foreign investment. Our public discussion of this crucial issue descended into raucous disputation that told China and the world that we were not at all sure about what we knew about ourselves.

On climate change, the Prime Minister in his Morrison Lecture said correctly that "...now, as the world's largest greenhouse gas emitter, and commensurate with its global role and influence, China must take on a greater leadership role on climate change. As an emerging power, China must take more responsibility to forge the solutions to the global challenges we face."

The Prime Minister is right to challenge China to take on a greater leadership role.

Those words also contain a challenge to Australia. One country's leadership carries at least some implication that when a lead is given in a good direction, others will follow. The Chinese domestic commitment to reduce the emissions intensity of production to 40 to 45 percent from 2005 levels by 2020 is the most ambitious, and the most important to the global climate change mitigation effort, that has been accepted by a major economy. It is a target so ambitious that technocrats close to the Chinese leadership advised that no such commitment should be made until more work had been done on how it could be implemented.

But the commitment was made by the President and the Prime Minister of China, and now forms part of the Copenhagen Accord. The National Reform and Development Commission has translated the general objectives into targets at a provincial level, for which Governors are individually responsible. If the provincial targets are not being met, the central authorities will intervene to close down the most emissions-intensive plants and enterprises. Plans are being developed to increase the costs and to inhibit the growth of the most emissions-intensive industries, including the manufacture of steel, aluminium and cement. Work is being undertaken towards identification of a year, sooner rather than later, in which the amount of coal combustion in China could be stabilized and then begin to fall.

China is making more rapid progress on expanding the role of low-emissions energy than any other major economy. At the same time, it has been reducing the energy intensity of production more rapidly than any other country. Realization that the emergency measures in response to the global financial crisis had caused some backward steps has led to a recent intensification of policy effort.

China is discovering through its commitment to action on climate change, that the difficulties and costs are falling more rapidly than anticipated. This has encouraged the strengthening of targets for increases in the role of renewable and nuclear energy.

The commitment to action is evident throughout greater China. China Light and Power, the owner of the main power supply capacity into Hong Kong, and of important generating capacity in Guangdong, and also here in the Latrobe Valley of Victoria, generates power for Hong Kong and Guangdong with a small fraction of the emissions intensity of its generation in Australia. And yet it is planning for large reductions in emissions in Hong Kong and Guangdong, to keep up with the Chinese commitment to reduce the emissions intensity of output by 40 to 45 percent, at the same time that in Australia it is part of the general business resistance to reductions in emissions.

Calling for Chinese leadership on climate change requires us at least to inform ourselves on what we might do to follow.

So far, the Australian polity has preferred the comfort of ignorance. How many times have you heard the ignorant statement, that Australia is justified in delaying action on climate change, because China and the rest of the world are doing nothing?

Some Australians would say that China should have led in a way that was more in tune with our own preferred way of moving forward. I would have preferred China to act more closely in concert with the recommendations of the Garnaut Review. The Garnaut Climate Change Review said that there could be no effective global agreement on climate change mitigation unless China accepted internationally binding targets. And I cannot help pointing out to my Chinese friends that the market-based instruments—a carbon tax or an emissions trading system—could achieve China's ambitious goals at lower cost than the current reliance on regulation. My advice to Chinese officials over the past two years has been that its own important progress on mitigation would be more effective in a global context if China were prepared to bind itself internationally to the targets that it has set for itself and towards which, with great effort and at least for a time at considerable cost, it is making astonishing progress.

Yes, China has things that it could usefully learn about the exercise of leadership in the new world of two and four great powers.

But if we are informed and honest, we will acknowledge that China is contributing to a the emergence of a strong global mitigation effort in a way that for the time being we are not. If we are informed and honest, we will acknowledge that China is exercising leadership.

If we are asking China to lead on climate change, we are bound at least to inform ourselves on where China is going, and would take us if we followed.

Regrettably, the gap between understanding and reality of global leadership at least on two great issues of our times—the gap to be covered by learning and knowledge; the gap to be bridged before we can usefully play the role of zhengyou—is wider in our own country than in the great power that is located in our own region.

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