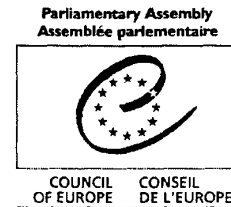


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Implications for Europe of the economic resurgence of China

Report
Committee on Economic Affairs and Development
Rapporteur: Mr Paul Wille, Belgium, Alliance of Liberals and Democrats for Europe

Summary

The economic rise of China – or rather resurgence considering the country's might in earlier eras – has profound implications for Europe. If Europe plays its cards right, this development can lead to major benefits for our continent and overall world stability and prosperity, including in the form of increased trading and investment opportunities.

The report goes on to examine the positive factors behind China's extraordinarily rapid annual growth of 9% or more but also the many social and environmental vulnerabilities that this breath-taking pace has opened up – including the growing gap between the rising wealthier classes and those left behind, such as in China's northern and western provinces. Other pitfalls are a fragile financial sector and often bloated and inefficient State-owned industries. Reforms have begun and Europe must support them.

The report also points to the need for China to make progress on human rights, democracy and the rule of law – areas which are of vital importance to lasting economic development. Here, Europe has a major role to play, not least through increased contacts via the Council of Europe and its Parliamentary Assembly. Europe should also pay attention to the wider implications of China's economic rise, for instance as it affects access to increasingly scarce fossil energy. Finally, Europe must ensure adequate protection of intellectual property rights in China, not least through the World Trade Organisation, of which China is now a member. The report concludes: "The West's future relationship with China will, if successful, have created a model for how the rich world can accommodate more of the planet. For this to happen, both sides will have to embrace change".

I. Draft resolution

1. The economic resurgence of China to become a major player in the world economy presents an opportunity to be seized by Europe in the form of increased trade, cross-investment, human contact and political co-operation. It is vital that Europe – whether in the European Union or in the larger Council of Europe area – adapt in time to this new realignment of the world's economic, and eventually political, forces, of which other rising powers such as Brazil and India also form a part. In adapting, Europe stands to benefit economically, whereas refusing to do so would not only jeopardize its own growth but also leave it increasingly isolated from the most dynamic regions in the world.

2. When considering China's spectacular economic rise to the world's third largest economy, it is worth recalling, however, the many pitfalls threatening to cap the country's long-term growth prospects. These include: yawning and widening gaps between rich and poor, between coastal regions and those inland and between young and old, leading to recurrent social unrest; serious water and air pollution, affecting the health and lives of millions; the loss of scarce agricultural land to expanding cities and industries; a fragile financial sector in urgent need of reform burdened by "bad loans" awarded to bloated and inefficient State-owned companies ripe with corruption; a rapid ageing of the population expected soon to lead to serious demographic imbalances and a shortage of pension funds to the elderly; and a one-party rule, far from the Council of Europe principles and increasingly ill-adapted to the requirements of a modernising economy.

3. The Parliamentary Assembly welcomes the growing recognition of these ills in the Chinese public debate and the new determination of the Chinese Government to pay greater attention to social, environmental and participatory concerns. The Assembly states its readiness to engage in further contacts with China's National People's Congress to share with it Europe's own experiences and possible solutions in these domains. It also looks forward to progress in China as regards the upholding of human rights, democracy and the rule of law – all areas of vital importance to lasting economic development. Introducing democratic government and respect for human rights would improve prospects for a balanced, rapid and undisturbed economic development.

4. The Assembly welcomes China's determination to undertake fundamental reform of its financial sector aiming at better governance, a reduction in the number of bad loans, a larger presence of foreign capital and financial institutions, the opening-up of domestic markets and a level playing field for foreign and domestic companies. It sees this as a natural consequence of China's membership since 2001 of the World Trade Organization and hopes that further progress may soon lead to the European Union's granting market economy status to China, with a resulting further increase in trade and investment between the two sides.

5. The Assembly also welcomes China's recent steps to permit its currency to adjust more freely vis-à-vis other currencies and recalls Resolution 1467 (2005) on "OECD and the world economy" adopted in October 2005 by the Council of Europe's Enlarged Assembly, in which it states its belief that "countries all over the world should adopt a more flexible exchange rate regime in order to gradually improve global imbalances".

6. The Assembly is aware of the widespread apprehension in Europe over intensifying penetration by Chinese companies in markets such as textiles and manufactures – in trade but increasingly also through investment in Europe-based production and retailing. It draws attention, however, to the enormous investment needs of China where European exports could excel. These include environmental facilities, education, healthcare, social and pension models, services, infrastructure, energy production, vehicles, housing, quality brands and luxury commodities – all areas where European companies have already made major inroads. Chinese tourism to Europe provides another important opportunity.

7. Finally, the Assembly calls on Council of Europe member states to pay greater attention to the wider implications of China's economic resurgence, such as the intensifying competition at world level for increasingly scarce energy, especially from oil and gas. In this context, it welcomes the European Union's growing contacts with China and the recent work of the OECD - for which the Assembly serves as a parliamentary forum via its Enlarged Assembly - on the Chinese economy and governance and resolves attentively to follow further developments. There is also the need to ensure adequate protection of intellectual property rights in China, an area where major shortcomings can be observed and have to be corrected.

II. Explanatory memorandum by Mr Wille, Rapporteur

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1. Introduction and background

1. In 1978, fewer than 1,000 people lived in Datang, on the southern Chinese coast – they were farmers, and in their spare time they made socks, by hand, and sold them by the roadside. Today, in place of the rice paddies, Datang is ringed by factories, kept running day and night: for this is "sock city", and tens of thousands of workers produce 9 billion pairs a year (more than a third of the world's total). Just to the west is "sweater city", and to the south, in a low-rent zone, is "underwear city". There are plenty of millionaires living around here. "I started out making socks by hand when I was 18" says Hai Yun Shi, "and now we have a contract with Walmart."

2. The people of Datang have an unfortunate distinction: having at first been condemned as "capitalists" by their own government, they are now the subject of trade petitions filed in Washington DC. They are ready to expand, they say; but will they be allowed to do it?

3. In the western press, stories like this are not hard to find. And for centuries, China has been a source of amazing headlines and astonishing statistics. From Marco Polo's tales of the magnificence of "Cathay", to the gunboat diplomacy of the 19th century, we have tended to see China's size as an opportunity. Recently, though, it has been seen as a threat: at first, because of its military machine, and now because the west fears for its own economic future. China leads the world in making toys, watches, bicycles, DVD players, digital cameras, computers...and so the list goes on. Will the rise of China be the most important story of our age, and what does it mean for the rest of the world? With a population of 1.3 billion – 1 in 5 of the world's population, and more than Latin America and Sub Saharan Africa combined - might it be that China's rise – or rather resurgence in view of China's economic might in earlier eras - spells the end of five centuries of economic domination by Europe and its colonies?

4. And yet, despite the importance of these questions, China is not well understood in the western world. Few would know that, even now, China represents only 6% of the world's exports - or that if China's economy were to collapse, the world's trading system might well collapse along with it. We are poorly equipped to succeed in one of this century's most important relationships.

5. In an effort to grasp the reality, and importance, of China's rise, this report will look at how the country's history has influenced its growth, and how economics is changing its social dynamics. By surveying at the new role of China in world trade, and its relationship to Europe, we will explore the extent to which our own dynamics may be transformed. Although this will involve a fair quantity of astonishing statistics, we will try to focus on the strengths that have driven China's growth, and the strains that underlie it. The Rapporteur has

traveled widely in China over many years, and more recently for the purposes of the present report. He is grateful to his colleagues on the Assembly's Committee on Economic Affairs and Development for the many comments and contributions they have furnished in the course of the Committee's consideration of this report.

6. One more consideration needs to be mentioned. This report will focus on the subject indicated, that is, *the economic resurgence of China and its economic relations with Europe*. It will therefore not take up the many other aspects of China that fall within the remit of other Committees of the parliamentary Assembly of the Council of Europe, such as the country's political system or the situation as regards human rights. It is not that the Rapporteur, or the Committee on Economic Affairs and Development, is indifferent to these values. Quite the contrary. But these essential aspects find their rightful place in a different report, not this one.

2. Modern China in the making

7. Modern China, like modern Europe, has been shaped by a long and proud past. In fact, China's recent growth is not so much a rise as resurgence. For most of the last two thousand years, it has been a distinct state, and a major economic power. In the year 1 AD, according to economic historians, China accounted for a quarter of the world's economy – and it was a major trading partner with the Roman Empire, who at one point tried to ban silk imports, because of the effect on the public exchequer. Run by a bureaucracy based upon the Confucian values of education, order and meritocracy, China regarded itself as the "middle kingdom", a haven of civilisation in the midst of a troubled world. To give just one example of its expertise: it was a Chinese scholar, in the 11th century, who invented printing – a skill that would take 400 years to find its way to Europe.

8. With a remarkable degree of administrative and philosophical continuity – and over time, a sprawling Empire - China was unchallenged as Asia's greatest player. In 1830, the population stood at over 300 million, and the country was still responsible for some 30% of the world's output. And yet, within a hundred years, China had effectively collapsed. Why?

9. Essentially, the old China collapsed because of its inability to deal with outside pressure – both economic and military – and it was Europe's powers that took the lead in this. In the early part of the 19th century, Europeans, and particularly the British, had tried to establish free trading relations with China. But the response was wary, and despite their vast appetite for imports such as tea and silk, they could find little that the Chinese would import from them. Instead, China sought payment in silver, and demand for the metal was pushing prices sky-high.

10. Opium was the solution - at first shipped openly from India, with its passage cleared by bribes – and then, when China attempted to resist, imposed upon the country by force. So in fact, the opium wars of the mid-century were about more than licensed drug-trafficking: at their heart was the Europeans' desire to retain their own legal jurisdiction on Chinese soil, and therefore their own commercial freedom. This was reflected in a series of "unequal" treaties, drafted by the victors. First Britain, then France and then the USA were accorded "most favoured nation" status, while Chinese waters and waterways were soon opened to foreign navies, and missionaries licensed to spread the Christian faith. Soon, harbours such as Hong Kong, Macau and Canton were "ceded" to foreign control. China's Imperial government was publicly humiliated and its inability to respond effectively was deepened by nationalistic rebellions. Just one of these – the Tai Ping rebellion – lasted for more than a generation and cost at least 20 million lives.

11. The disasters of the 19th century prompted a debate amongst China's elite. In his ground-breaking "Gazeteer of Maritime Countries", written in 1842, an official named Wei Yuan argued that China should learn from the methods of the west. "There are many intelligent people in China," he pointed out, "surely there are some who, having learned from the barbarians, can surpass them". And indeed there was an attempt at "self-strengthening", a process of modernisation and reform, but the government was unable to command credibility and support across its vast territory.

¹ The present report emanates from a Motion for a Resolution (Doc. 10443) presented to the Parliamentary Assembly in January 2005 by Mr Goerens and several of his colleagues. Already in 1988 the Assembly adopted Resolution 897 on economic relations and cooperation Europe and the People's Republic of China. (Rapporteur: Mrs Herfkens.)

12. Foreign power became instrumental in suppressing disorder and so helped keep the government in place, while constraining it from reform. By the end of the century, the world's powers – chiefly Britain, France, Russia, Japan and Germany - had established 'spheres of influence' in every corner of China, while the US moved toward an "open door" policy, allowing any country access to trade, so as to bolster its own position. Ironically it was the Japanese, under the Meiji Restoration, who picked up on China's "self-strengthening" efforts and proved better able to implement their ideas. With a newly-aggressive ideology, Japan embarked upon what would be half a century of attacks upon, and occupation of, Chinese territory.

13. As in Russia, China's imperial system took some time to crumple. At first, under the idealistic leadership of Sun Yatsen, a democratic solution seemed possible, but a protracted civil war developed, between nationalist and communist forces. This appeared to end in the defeat of the communists, who were forced to flee, in what became known as the Long March of 1934/5 (at its lowest point, there were only 400 people taking part). But corruption and ineffective government destroyed the credibility of the new government – and their troops preferred to attack the once more invading Japanese, rather than pursue their own countrymen. By the time of World War Two, the American general leading resistance in China reported that the communist fighters were far more effective than the nationalists (they are also thought to have made a fortune by smuggling opium). After the war, the civil war resumed, and this time the communists had the upper hand. To this day, there remains controversy over whether the Americans hastened a communist victory by urging a truce upon the nationalists – but at all events, on 1 October 1949, the Peoples Republic of China was declared.

14. By this point, China's share of world output stood at around 5%. After so many years of conflict and decline, a conclusive communist victory was widely welcomed. China's borders, and her imperial past, were reasserted – in particular through the settlement of the Korean War and the invasion and occupation of Tibet. To begin with, there was a close partnership with the Soviet Union: farming was collectivised, and an emphasis placed on industry, in an echo of Stalin's five-year plans. Both countries proclaimed the need for socialist self-sufficiency. But as Mao consolidated supreme power, he began to show himself one of the century's great killers – in the late 1950s, the Great Leap Forward was supposed to transform China's industrial position, and help the country surpass the US in steel production within 15 years. The result was mass starvation (and a collapse in steel production), and after three disastrous years the regime admitted defeat. But by the mid-1960s his faction was once more in the ascendant; and with China now alienated from the Soviet Union, Mao personally launched the Cultural Revolution, which became, in effect, yet another civil war.

15. How many died under Mao? It is hard to say, though perhaps the number was around 80 million – and for those who survived, the social and economic effects were catastrophic. With the slogan "Better Red Than Expert", the educated elite was decimated, and the country's heritage and infrastructure was systematically ruined. When the Cultural Revolution fizzled out, Mao's twilight years formed one long, depressing, factional struggle for the inheritance of a wreck – although Nixon's 1972 visit intrigued many in the west as to China's possibilities.

16. When Mao died in 1976 there was chaos – and China's economy was still no stronger than it had been when the communists came to power. Led by Mao's widow, the "Gang of Four" pushed for a continuance of radical policies, but over the course of several years a new, and unexpected, leader emerged. This was Deng Xiao Ping, the son of a peasant, who had trained in Paris and Moscow, and had twice been purged by Mao (for a time, he was sent to work in a remote engine plant). A veteran of the Long March - the highest badge of communist honour – Deng now had the "Gang of Four" imprisoned, and began the journey from state controls to the market, and from economic independence to global integration.

3. **"It doesn't matter if the cat is black or white, so long as it catches mice"**

17. This phrase, perhaps the most famous of Deng Xiao Ping's wry asides, neatly sums up his policy. He championed the idea of a "socialist market economy" – also to be known as "socialism with Chinese characteristics". And first of all, collective farming was replaced by a "responsibility system", which decentralised rural decision-making, allowed peasants to sell the produce of their own plots at free markets, and enabled villages and municipalities to invest in whatever projects they considered would be profitable.

18. Time and again, both in the countryside and in the cities too, as growth gathered pace, the government allowed local leaders to be seen to force the pace of change. Although Deng himself provided much of the theoretical background (and encouraged the development of an expert bureaucracy to replace Mao's zealots), reforms would seem to appear by local inspiration, often in contravention of existing laws. If they proved successful, the government could then adopt them.

19. The resulting stimulus improved the desperate state of rural life – for a time, agriculture's share of GDP even rose, to 33% - and provided the springboard for Deng's most ambitious changes. For, while stressing the primacy of agricultural output, a series of Special Economic Zones were set up in seaboard cities such as Shenzhen and Zhuhai. Foreign businesses were encouraged here, via joint venture arrangements, and offered low levels of regulation, as well as tax concessions, in return for investment revenue and technical knowledge.

20. Interestingly, the foreign investment boom was driven by overseas Chinese, who were welcomed for political, as well as economic, reasons. From 1985 to 1996, two thirds of the external investment came from Hong Kong, Macau and Taiwan. These places specialised in labour-intensive manufacturing for export – and in effect, they transferred their trade surpluses with America to coastal China. This was the beginning of export-led growth, and a decisive rejection of Maoist self-sufficiency.

21. This did not, of course, mean the demise of central planning. A new bureaucratic elite would continue to protect state enterprises, particularly heavy industry; it is worth noting that even in the late 1970s, when the bulk of the population still worked on the land, 50% of China's GDP was accounted for by industry. Finance was now provided by the state-controlled banking system (underpinned by high consumer savings rates), so that, although more autonomous than before, the businesses were not subjected to market forces. They were, however, encouraged to invest in modern machinery and technology – and permitted to import it from the West.

22. Commentators were soon hailing an industrial revolution in China. And meanwhile, Deng attempted the implementation of a system where the Party develops policy and the State executes it, with the President and Party Secretary being two different people, and the President acting as mostly a figurehead. But the apparently relaxed and optimistic mood was dangerous, for it led to series of disastrous miscalculations. In May 1989, following a visit by Mikhail Gorbachev and the funeral of a popular, liberal party chief, students occupied Tiananmen Square to call for speedier reform. They saw themselves as echoing a famous patriotic protest that had taken place there exactly 70 years before, and similar protests that had helped to bring down the Gang of Four. They believed, too, that they had General Secretary Zhao Ziyang on their side. After days of indecision and in a mood of growing panic, the party – at Deng's behest – sent troops to the scene. Perhaps 7,000 protestors were killed - but whatever the true figure, the damage to China was severe, for the world's press was on hand as the tanks moved in.

23. The West, of course, was appalled - while the Chinese regime was both shamed by having felt forced into such public acts of suppression, and fearful of the consequences to itself. For three years, while dissent was thoroughly, and more discreetly, suppressed, reform was put on hold. But in the spring of 1992, Deng felt confident enough to tour the Economic Zones of southern China, with his speeches closely covered by the media. He stressed the importance of economic reconstruction, attacked the enemies of reform and declared that 'leftist' elements of Chinese society were far more dangerous than "rightist" ones.

24. Many in China regarded this as a way of making up for the "mistake of Tiananmen Square – and the West, which had imposed a series of trade embargoes, was quick to re-engage. China's rapid growth rate was soon resumed, and liberalisation continued apace. By the time of Deng's death in 1997 – shortly before the symbolically (and economically) important handover of Hong Kong - a smooth transition of power had already been put in place. Today one of his protégés, Hu Jintao, heads China's fourth generation of Communist leadership, and presides over the longest stretch of public calm since the days of the opium wars.

4. China's perilous rise

25. Between 1980 and 2003, China grew at an average rate of 9.5% per year, with real incomes rising by 300%, and GDP per head increasing faster than in any other country. In the last decade it has attracted foreign investment of \$560 billion and is now the world's third largest economy (and already the second largest, if one uses purchasing power parity figures), accounting for around 15% of the world's economic activity. The United Nations Conference on Trade and Development (UNCTAD) places China as the largest recipient worldwide of foreign investment, around \$ 60 billion in 2004. It is in this context noteworthy that foreign investment today is not only in vehicles, the chemical industry or in electronics and other industrial activities, but increasingly also in research and development, hi-tech and services.

26. And yet, this is still a far cry from China's economic importance in the last century. With 20% of the world's population, it would be natural to think that Chinese growth still has a long way further to go. As we shall see, there are good reasons for thinking so – but there is plenty of room for skepticism, too. For the country's strengths are balanced by a range of risks and uncertainties, and the West needs to take account of these. For China's rise is both less spectacular and less confident than it looks.

27. Since 1978, the trend of China's GDP growth, compared to that of the US, has been no aberration. In fact, it is broadly similar to that achieved by Japan, South Korea and Taiwan in the previous generation. China is on the same path of rapid convergence with the western economic world that has characterised Asia's development (and upon which India is also embarking). There are, though, two key differences:

- First, China has begun from a much lower base than its predecessors. In 1950, when Japan's boom began, its GDP per head was already around 20% of US levels; but for China in 1978, GDP per head was just 5% of that in the US, and even today it has only reached 15%. So China has yet to reach the point from which Japan started – and has now achieved income levels, relative to the US, that South Korea attained in 1972, and Taiwan in 1966. There is, then, a long way for China still to go – and its growth surge is, potentially, in its early stages. Why, then, are economists doubtful about China's prospects?
- The second key difference explains the problem. Each generation of catch-up economies is expected to grow faster than the last, since their growth potential is driven by how far they are behind the productivity levels of the top economies. And yet China's growth rate has been less spectacular than its predecessors. When adjusted for comparison over time, China's GDP per head rose by 370% between 1978 and 2004. Yet between 1950 and 1973, Japan showed growth of 460%, while between 1962 and 1990, South Korea recorded 680%, and between 1958 and 1987 Taiwan achieved 600%.

28. Taken together, these factors are intriguing. At first sight, China should already have been able to outperform its predecessors, but it has not done so. In fact, on current trends it will take China more than a quarter of a century to achieve the level of GDP per head that Japan has today. And in thirty years or so, when its economy is likely to be of similar size to that of the US, its GDP per head will be at the same level, in proportion to that of the US, as South Koreans enjoy today.

29. As Alwyn Young, a University of Chicago professor, says, China's growth has been "respectable, but by no means extraordinary". Two remarkable facts need to be kept in mind. First, every single economy that has caught up with the west since the Second World War is located in East Asia. And second, the only two East Asian economies not to have caught up are China and North Korea. On current form, China may well become an economic giant, without becoming an affluent country.

4.1. *Not quite an "Asian Tiger"*

30. Like in previous "tiger economies", stability – or a lack of democratic pluralism – has given China an aura of common purpose. Investors have felt confident of the government's ability to enforce its will and reforms have been relatively well managed, especially when connected to foreign trade and investment. This has been by no mean feat, given the size of the country and its previous circumstances, and Lord Desai, of

the London School of Economics, underlines the contribution of China's historical identity; it remains, he says, a "unitary hard state, which can pursue a single goal with determination and mobilise maximal resources in its achievement."

31. China's most significant move of recent years was its accession to the World Trade Organisation, a process begun by Deng in 1986, but only concluded in 2001. For a country attached to the notion of self-sufficiency and jealous of its own jurisdiction, many painful choices and compromises were required along the way, with timetables being set for market reform and open access for foreign investors, and curbs upon agricultural subsidies. In the end, though, the government wanted the benefits of WTO membership so much that they were prepared to risk possible social unrest and to ignore criticism from both ultra-nationalists and the state owned monopolies.

32. This has been a watershed, for China is now committed to a much greater degree of openness than was the case for previous tiger economies, and cannot turn back without risking what it has gained so far. Foreign firms have increasingly strong positions, right across industry, and though still unable to take controlling stakes, that will soon be increasingly possible; even today, it is easier to invest in a firm in China than in Japan or Korea.

33. All this has driven the pace of growth, of product diversification, and of quality improvement. Previous Asian growth economies have relied much more on the development of strong indigenous companies, with massive research and investment spending and innovative manufacturing techniques that have been exported to the west. China is currently nowhere near being able to emulate this – and instead, Chinese firms are being encouraged to develop their own capacity, both by learning from their joint-venture experience and, increasingly, by acquisition overseas. This double strategy is designed to address lack of a world-class industrial company and world-class brands. It has also stepped up spending on research and development, to become the world's third such largest investor.

34. The government has enabled rapid growth via a strong system of universal primary education, (although it has not been universally free of charge). Illiteracy has been reduced from 20% to 4% in 20 years, and the World Bank reports that while Chinese labour is now 25% more expensive than that in India, superior education means that it is 50% more productive. There has also been a huge commitment to vocational training, and some 350,000 engineers graduate in China every year.

35. So, in a generation, the economy has been reshaped. Agriculture now accounts for less than 15% of GDP, with tertiary industry and services making up 30%. While heavy industry still represents 50% of GDP, the share of industrial output accounted for by companies in which the state holds an interest had shrunk to 40%, with wholly-owned state companies making up just 15%.

36. What is more, China still has a hard-working, flexible and relatively cheap workforce, with average labour costs still only around \$1 an hour. And there is a huge reservoir of potential labour, ready to migrate from the countryside. With high investment levels, strong demand for its products around the world and a development-minded government, China still seems to have the basic ingredients required for continued rapid growth

37. For any visitor, China's achievements are plain to see: the skyscrapers, the highways, the ultra-modern airports and so on – all are designed to demonstrate China's new status in the world. But it is worth asking how this boom has been financed – and whether it is sustainable.

4.2. *China's growth has been uniquely expensive*

38. The key to rapid economic growth is, of course, investment - and investment levels in China have been extraordinarily high, recently running at over 40% of GDP. This is well ahead of the levels achieved by previous Asian catch-up economies (and at least double the amount seen in developed countries). Why, then, is growth not faster?

39. So far, at least, China's allocation of investment capital has apparently been inefficient, with a ratio of investment to additional output much lower than its Asian predecessors. One important reason is the long-standing focus of investment on large state enterprises – the state sector securing more than 60% of all business credit in the 1990s - a phenomenon not seen before in Asia growth economies. Meanwhile, according to a study by IMF economists, whilst private investment accounted for between 15% and 27% of total investment during the 1990s, (being restrained by a lack of access to bank lending), those same private firms created 56% of the country's new employment.

40. As this suggests, China's growth – and the economic exuberance seen by the rest of the world – is confined to a relatively small area of the economy. This is still more evident when looking at foreign direct investment. Another study by IMF economists shows that while FDI was equivalent to only 4-5% of China's GDP during the 1990s, it generated almost all of China's economic efficiency gains. The share of China's exports held by foreign-owned companies is, accordingly, around 50%, and their share of total industrial output has risen from 12% in the early 1980s to 29% by 2002.

41. There are many possible ways of reading this. China's exceptional size and long-standing poverty have required massive investment in infrastructure such as roads, rail, electricity generation and water – and as we shall see, the country is finding it hard, even so, to keep pace with its levels of growth. Investment of this type is vital, and though it has been slowed somewhat in an attempt to prevent overheating, it is likely to continue on a large scale for many years. But there is increasing evidence that China's return on the money spent so far has been poor – with surpluses in some sectors going alongside shortages in other, and critical infrastructure problems still apparent.

42. Some believe that China's demand for investment is insatiable: there is, for instance, a huge backlog in property provision, particularly in housing, as the population becomes increasingly concentrated in cities. And while there is strong spending on areas such as education, the decline of state-owned companies has left a yawning gap in social provision. Not surprisingly, then, the government is reluctant to reduce subsidy levels quickly, and there is still heavy spending on outdated enterprises. Meanwhile, a fear of foreign dependence leads to uneconomic activity, for instance in the production of expensive, low-grade coal.

43. It may be that, as the longer-term infrastructure investments pay off, and the subsidies fall away, China's potential for growth will become spectacular. Given the current lack of financial transparency and political accountability, it is hard to be sure of the true extent of waste, incompetence and abuse in the system – but it must be a significant risk. The Communist Party has itself acknowledged that tackling corruption is a top priority, and meanwhile the country's banks are in an astonishingly exposed position that hints at how poorly much of the money has been used. For in the world's fastest-growing economy, some 40% of existing loans are considered as bad debt.

4.3. *The banking & finance sector is in controlled crisis*

44. With nothing much to spend their money on, and few investment options, Chinese people have been in the habit of saving too much, and putting it all in the bank. The current savings level, around 44% of Gross National Income, (as a comparison, it is 22% in India), has helped the government to prop up state industries, but has not brought the savers much of a return. In fact, Chinese analysts have long pronounced China's banking system "technically insolvent" and, in implicit agreement, the Chinese government has injected more than \$60bn to recapitalise the system.

45. True, China is ahead of the game with respect to banking sector reform and it is vital that banks begin to operate according to market principles. However, this is a massive task. There has been rapid change, but it will be several years before the banking system can distribute domestic savings efficiently. Banking sector workers, whose job up to now has mainly been to stamp the loans to state-owned firms, will have to acquire many new skills, such as credit-risk analysis. Moreover, for it to be successful, China will have to go further in reforming the state-owned enterprises.

46. Leaving the domestic savings in the hands of state banks, which lend primarily to state firms without being governed by market principles, has resulted in massive over-investment, and limited China's ability to stimulate consumer spending. The authorities are unable to encourage car and mortgage loans and have recently had to restrict even the existing types of household loans, because such a large proportion has become bad debt.

47. Fixing this will not be easy: China's banking regulator recently stated that the officials found to be responsible for bad decisions leading to bad debts will be punished severely and could be prosecuted but of course this will do little for bankers' enthusiasm to lend according to market principles. If successful, current banking sector reforms will be beneficial in the long term, but in the short term they are likely to be highly disruptive.

48. Meanwhile, reform hopes have suffered as the same regulator has announced that the authorities are considering restricting expansion by foreign banks – both by limiting the number of stakes in domestic banks and directing them towards economically backward provinces. Foreign banks were already nervous of becoming burdened with Chinese debt, and have been wary of investing, despite WTO rules that will require China to fully open its banking market by January 2007.

49. This situation has serious implications, for economic development will falter without a properly functioning financial system. Chinese businesses have no choice but to rely on banks as a source of domestic credit, because of the calamitous state of equity markets. Over the last five years, prices on China's stock markets have actually fallen by two-thirds, while allegations of fraud and mismanagement have flourished.

50. This has been partly due to restrictions on outside firms operating in the markets, and partly to the artificial nature of company listings. In the 1990s, when the government began listing companies, many of which were poor performers, most of the equity was held back as non-tradeable shares – and foreigners were only able to buy "B" shares, without voting rights. The effect of this has been to block corporate reforms and, as the performance of companies did not improve, to discourage new flotations. Now, therefore, whenever it is hinted that these shares might be disposed of, the market tumbles.

51. Gradually, the government is seeking to overcome this, with a mixture of reforms and bail-out funds. But in the end, the market will force a choice between private ownership and state control. In seeking to have the best of both worlds, China has, in this case, the worst of both. If a stock market is to work, it must be able to set the value of the firms listed upon it; and if investors are to have confidence in the system, corporate governance laws will need to be enhanced. The logic of a market will also demand that foreign institutions and brokerages should be able to play a full part – Hong Kong provides China with an example of how successful this can be. For European business, expertise in financial services promises to be one of the great opportunities in China during the next few years.

4.4. *Reconciling urgent objectives: a tall order*

52. As China sets about the task of developing into a modernised, middle-income developed country, it faces a host of formidable challenges. A first will be to secure the necessary natural resources – especially energy, raw materials (including agricultural land) and water – which, as we have seen in the preceding chapters, requires not only obtaining them domestically or from abroad, but also using them efficiently.

53. A second challenge will be to reconcile economic growth with a better protection of the environment – by reducing pollution and waste and encouraging recycling – and a third to do so while at the same time ensuring social improvements for the broad masses of the population across all regions.

54. The social challenge has numerous components:

- setting aside sufficient funds for social protection while maintaining rapid economic growth;
- keeping unemployment low even as technological advances are made that lead to lower labour input;
- making development more even as between the vibrant coastal areas and the often underdeveloped interior of the country, as well as between the rich and the poor;
- developing the cities without overly destroying precious agricultural land;

- attracting foreign investment and making sure that indigenous companies can still survive and become more efficient;
- and intensifying economic reform while maintaining social peace and stability.

4.5. *Reform of the financial sector*

55. The Rapporteur's Chinese interlocutors left no doubt that – after the agricultural reform of the 1970s (still far from concluded) and that of state-owned enterprises in the 1980s – financial reform is next in line.

56. Toward this end, a number of major domestic banks have already received infusions of state funding as a precursor to change, but foreign banks are also expected to play a major role, both in providing fresh capital and, above all, in forcing domestic banks to observe higher lending standards and corporate governance generally. Although foreign shareholding in domestic companies is still a relatively rare occurrence, the longer-term aim is to permit a level playing field between foreign and domestic investment, and a rapid reduction in bad loans especially to state-owned companies.

57. Foreign and domestic enterprises are also foreseen eventually to sort under one and the same tax regime. Indeed, since 2002 foreign banks can gain access to the Chinese market as so-called Qualified Foreign Investment Institutions (QFIIs). Their combined capital now amounts to around \$ 10 billion. (Considerable funds incidentally came from Hong Kong - often in the form of capital that once was unduly transferred by managers of state-owned enterprises to Hong-Kong and is now being returned.)

58. The difficulties in carrying out the bank reform should not be underestimated, especially since at the same time the state-owned enterprises will have to be made more competitive and the number of small and medium-sized enterprises substantially increased. It is significant that the financial reform effort is to be administered not from Beijing but from the financial hub of Shanghai.

4.6. *China's currency: "crossing the river by feeling the stones"*

59. China's recent "loosening" of their currency's peg to the dollar – and the linking to a still inscrutable "basket of currencies" - seems, at this point, more symbolic than real, but there are hopes that it will have long-term importance. If the currency were freely traded, it would be significantly stronger, and this would tend to encourage imports and discourage exports. Such a trend would be natural, for, with a surging economy and a huge population, China is the sort of developing country that would be expected to run a current account deficit, financed by long-term capital inflows. But with the pegging of the currency, this has not happened, and the trade surplus has continued to soar (in 2004, it rose 25%, to reach \$32bn), as the dollar has depreciated. This has made the trading situation more difficult for European firms, especially in the eurozone.

60. The reluctance of the Chinese government to free its currency is understandable, with long-standing fears of foreign domination mingling with concern about economic management being at the mercy of international capital markets. Heightened rhetoric from the west is more likely to slow the pace of change than hasten it. The Chinese government believes that 15 to 20 million new jobs need to be created annually, so as to match population growth, urban migration and the slimming-down of old state-owned firms – so the continued growth of exports is vital.

61. But in order to maintain the exchange rate, China has been forced to buy dollars, which are then placed in US bonds, and play a large part in financing the US's massive deficits. In effect, China is trading its manufactured goods in return for US Treasury Bonds - and the savings of Chinese peasants are being used to underwrite the world's current economic trading structure. China now finds itself holding currency reserves equal to a third of its own GDP, double the level of only three years ago.

62. This is an increasingly absurd position for China – as it is for other Asian countries with similar policies – and it is clear that the government knows it. For of course, the value of the bonds would plummet, were it to try to cash them in, and increasingly it finds itself in a policy straitjacket that will hamper its long-term development. The current situation invites inflation and attempts to restrain this are putting even greater

pressure on the banking system. It would be far more prudent for China to run modest deficits, especially given the healthy levels of foreign investment, but one should expect any loosening to be cautious and gradual - or, to use an image of Deng Xiao Ping's, "crossing the river by feeling the stones."

63. Any change will also require fiscal consolidation in those countries running deficits, too, for the impact on the world economy of a sudden meltdown or debt default would be traumatic. To solve the problem, there will have to be cooperation; as Martin Woolf of the Financial Times puts it, "it takes two to tango".

64. China has at long last begun to gradually adapt the renminbi to international markets. Prior to 1994 the country observed a fixed (in effect dual) exchange rate vis-à-vis the dollar and other major currencies. Since 1994, a managed, floating exchange rate regime has been practised, where the Central Bank sets a narrow allowed range and intervenes to defend it when necessary.

65. During the 1998 Asian financial crisis, China permitted the renminbi to reappreciate somewhat, an action which helped other countries in the region to weather the storm. Since that time, China has gradually continued to prepare for currency reform by restructuring commercial banks, reducing foreign exchange controls and permitting, more recently, moves of up to +/- 0.3% in the value of the renminbi vis-à-vis a basket of other currencies - including the dollar, the euro, the Japanese yen, the Korean won and a few others.

66. The planned, gradual freeing of the renminbi has several objectives. They include easing the external trade imbalance; boosting domestic demand, strengthening the competitiveness of Chinese companies; opening up the domestic economy to international competition; and preserving price stability.

4.7. *Resources and the environment: the natural price of growth?*

67. China is lucky to have been able to expand without having to spend much of its currency on energy imports, for it has a great supply of natural resources. Its oil reserves are substantial, and in the past, it has been able to produce enough to supply its own needs. But last year, it became a net oil-importer for the first time.

68. In part, this is because the state-owned oil companies are relatively inefficient, and do not have sufficient expertise to extract oil from increasingly challenging locations. In response, the Chinese government has begun to seek international partners; and the search for better technology is one reason for the bid by Chinese oil giant CNOOC for the US company UNOCAL. It is also one reason for the outcry amongst US lawmakers, despite UNOCAL's oil reserves being predominantly located in Asia.

69. But China's overriding problem is booming demand. China is now the world's second largest oil consumer - its demand has virtually doubled to 6.5 million barrels daily since 1995. This represents a quarter of the world's entire demand growth, though it should be borne in mind that US consumption is still more than three times that size. China's expanding demand is partly a general function of growth - given that China, like the United States, does not have an energy-efficient economy - and partly a specific function of poor electricity distribution, forcing companies to install diesel generators. The International Energy Agency expects China's oil demand to double again, at the least, by 2030.

70. China has coal reserves of about 125 billion tons, but again, it is increasingly difficult to extract, and much of it is low-quality. China's mining industry is the largest (and most dangerous) in the world, with production having risen rapidly in the last few years to around 2 billion tons (a third of the world's total). But in China's main coal-mining area, 100,000 jobs have been lost in the last decade. In fact, of 118 cities in China whose economies rely on natural resources, at least 30 are running out of supply - and six have unemployment levels over 20%. Recent government reports on the social situation in these areas speak of "serious and complex problems."

71. Just over half of Chinese coal is used for power production, accounting for over 70% of all the country's electricity, but demand has been growing at well over 10% per year, and production struggles to keep up. According to the government, the present size and scale of China's coal industry are far from being able to meet the country's future market demand - and the economics of the problem are complicated by the artificially low prices that generating companies pay.

72. For a country with a self-sufficient ethos, maintaining energy supplies, and diversifying their sources, has become a major preoccupation. Plans are underway to develop gas production, to convert coal into liquid oil, and to develop additional hydro-electric capacity, as at the Three Gorges Dam. There is also research into renewable sources (in remote areas, some villages use solar panels to heat water). But increasingly, China is engaged in a search for secure supplies around the world - and this, as we shall see later, is one of the greatest potential threats to relationships with the west.

73. Meanwhile, the Chinese economy has been constrained by the high commodity prices for which its own growth is partly responsible - and to a greater extent than in Europe, because of its energy-intensive economy and its dollar-based currency. In fact, China's economy has been a victim of its success in many ways - higher prices for commodities and raw materials, higher shipping and distribution costs, and surges in the price of food.

74. As suggested above, unreliable electricity distribution is a major weakness for China. Last summer there were persistent blackouts. Fuel stockpiles have become very low, and in a country of this size, where transport is overloaded, moving materials to the right place at the right time can be challenging. With a rigged market, aging stock and managerial ineptitude, the state-owned generating companies are in dire need of reform, if China is to maintain its growth. China's electricity use per head is still only a tenth of that in the US, and the IEA estimates that China will account for 25% of the world's total electricity increase over the next 30 years.

75. This underlines the question of efficient use of investment that still bedevils Chinese growth. Another recent example is the glut of steel, due to the establishment of too many steel plants in provinces all over China, in an over-reaction to rising demand. The world steel price, which had been very high because of Chinese demand, has now come crashing down, as surplus Chinese steel floods into world markets.

76. In 1999, China's current Prime minister warned that "the very survival of the Chinese nation" was threatened by water shortages. But China's supplies have continued to fall, as it faces drought (aggravated by bouts of exceptional flooding), rising demand and long-term environmental problems. Pollution, deforestation, and the advance of the north-western deserts are among the key challenges, made worse by misguided communist works projects. River levels have fallen sharply, and across much of northern China, water tables are dropping by around a meter a year. Every day there are more than 1000 additional cars on the streets of Beijing.

77. Half of the raw sewage produced by China goes straight into the country's rivers and lakes. 400 out of the country's 670 bigger and middle sized cities do not yet have water treatment. Improvements in water quality are vital also for the life expectancy of the population.

78. Although China is investing heavily in garbage and sewage disposal - an area where the scope for foreign investors is again huge - much remains to be done, and the construction of new capacity still lags behind the pace of urbanization, leaving nearly half of the country's major and middle sized cities without a plant.

79. China has 21% of the world's population, but only 7% of the world's water resources. Efforts are under way to raise the sanitary standard of drinking water to a more internationally recognised level. The government also tries gradually to raise the price of water in order to have the population use it more responsibly. There is also an effort to introduce the "polluter pays" principle. As foreign water utility companies are invited to invest, one challenge will be to ensure that prices in such a more liberalised market remain fair to consumers.

80. In the countryside, one person in three lacks access to clean water, while more than 100 big cities suffer shortages. Hydro-electric power yields have declined, while industrial mills, smelters and factories are no longer sure of supply. And yet, water prices are still around 40% below cost - before 1985, it was not charged for at all. Raising prices, investing in water technology and tackling environmental issues are a priority if China is to tackle the threat of an ecological catastrophe.

81. A recent example of environmental damage was the contamination, in November 2005, of the river Songhua from an 80 km long chemical spill accidentally released from a chemical industrial complex. The spill of highly toxic nitrobenzene put some 4 million people in the city of Harbin at risk and also endangered the Russian city of Khabarovsk. It was possible to safeguard public health in Harbin only after drinking water from other parts of the country was brought into the city, until the spill had passed.

82. The World Bank estimates that 400,000 Chinese citizens die every year from environmental pollution. The rapid industrialization and the spread of deserts lead to a further reduction in the already scarce amount of farm land. The incidence of acid rain and serious diseases as a result of river and lake pollution from the chemical, paper and dyeing industries are on the rise.

83. The environmental clean-up is rendered more difficult by the reluctance of many companies to sacrifice rapid profits in order to make costly investments to reduce pollution. They will often ignore directives from the capital, in accordance with the old expression that "The sun is close and the Emperor far away".

84. In the summer of 2005 the Chinese Minister of the Environment, Mr Xie Zhenua, presented his country's policies in this domain before the Belgian parliament. He confirmed that, contrary to the previous policy of "economic-growth-first: environment-protection-later" had now been replaced by one where environment protection formed a very high priority indeed. He mentioned that in the western provinces it was estimated that 13% of productivity was lost due to environmental degradation. For example, in the past waste and garbage were often shipped for deposit high up in the mountains, with the result that the pollution came down with the rivers to the plains, causing massive pollution. Some 300 million Chinese are estimated to drink unsafe water due to pollution from permanganate, ammonia, nitrogen and oil.

85. A "green GDP" has been introduced in a number of cities, as part of a joint project between China and the World Bank, signifying that the measuring of growth is not restricted to economic variables alone, but also include environmental improvements.

86. Poor environmental conditions are amongst the factors driving China's people from the land, where 60% of people still live – even though China has 16 of the world's twenty most polluted cities. The UN projects that the rural population will have fallen to 40% of China's total by 2030. Arguably, it is not a process the government could now stop if it wanted to. Over-cultivation, and the appropriation of farmland for development, have made the problem worse, so that some are now asking: can China feed itself?

87. The short answer is that no one knows. With a population projected to 1.48 billion in 2025, most experts believe that China's resources will probably be sufficient, but that better agricultural technology should be a priority, and that water supply needs must not be neglected. In years of poor harvest, too, China will have to import substantial quantities of grain, as it has done several times recently, and this could be on a scale that would significantly raise grain prices. China's environmental crisis will have direct implications for the whole world – but its strongest impact may turn out to be upon China's political system.

88. In October 2005 the Chinese communist party approved the country's 11th five-year plan for the period 2006-2010. The plan talks of building "a harmonious society" through "scientific development". The plan, needless to say, is able to govern less and less of China's increasingly market-led economy, but it is still closely watched since it expresses the priorities of the Communist party leadership, which controls the financial system and the strategic industries such as energy.

4.8. *One country, one possible government*

89. With some 66 million members, the Chinese Communist party is the world's largest political organisation. Its hold on power remains tight – organised dissent is suppressed and free trade-unions non-existent. Although the number of political prisoners has declined since the early 1990s, (with the exception of Falun Gong members, who have been jailed *en masse* since demonstrations in 1999), the criminal justice system continues to horrify western observers, with widespread abuse of prisoners reported, and appalling detention conditions. Amnesty International estimates that China staged over 1,000 executions in 2002, almost 70% of all executions recorded worldwide.

90. Some progress has been made in tackling government bureaucracy and the application of law, particularly where business is concerned. Although Transparency International ranks China only 71st in the world for corruption, and 112th for economic freedom, investors report that contracts have become easier to resolve and enforce, and that property rights have improved dramatically since China's accession to the WTO. The government is determined to show that it can get things done, as the huge upheaval ahead of the Beijing Olympics is demonstrating – and businessmen are often astonished to find that Chinese provinces compete against each other, expertly and energetically, to secure investment

91. And to this extent, it seems that they have the support of the people. Although it is impossible to gauge opinion with certainty, observers report a high degree of support for the goals of economic growth, and establishing China as a world-class power. National pride is being ostentatiously restored, and issues of national identity – in particular the attitude vis-à-vis Taiwan – command a striking consensus, even among liberals. Across most of China, the atmosphere has relaxed in recent years – with particular change seen at local levels. Elections have been held in villages and some urban districts, and in some party bodies. Internet usage has been allowed to surge (albeit restricted by a "Great Firewall" of censorship), and the media has been encouraged to challenge and to investigate, within limits. By and large, though, the government clings to the idea that improving the quality of officials and official practices is the answer, which is, after all, very much a Confucian notion. And so, as the Economist puts it, people are free not to bring political change, but to ignore politics

92. In November 2005, the Chinese government issued a policy "White Paper", in which it gave its own definition of what it called its country's democracy. "Democratic Government is the Chinese Communist Party governing on behalf of the people... while upholding and perfecting the people's democratic dictatorship", the document said. It claimed that over the past two decades China had made substantial improvements in its political system, strengthened the protection of disadvantaged groups and streamlined its administration. The paper made clear that no fundamental change in the country's political system can be expected any time soon. Only at local level will there be village and municipal elections at least somewhat resembling the western idea of democratic government. The document hailed China's commitment to freedom of expression and pointed to the large number of newspapers, publishers and internet users, while making no mention of the country's censorship system or of the many people jailed for their political beliefs.

4.9. *Social stress, and a rising tide of protest*

93. It is hard to over-estimate the challenge that China's growth poses to this model. Increasingly, China is a collection of regional economies, connected, but with wildly different levels of prosperity. According to police figures, there were 58,000 demonstrations in China last year, a rise of 15% - interestingly, mobile phones have become an important tool for protestors - and in some provincial cities impromptu roadblocks are a common occurrence. In 2002, though little covered overseas, the Party faced its largest ever protests, when former state workers took to the streets of north-eastern cities, citing the non-payment of welfare, income and severance benefits, and the enrichment of party officials.

94. Government attempts to reform state-owned firms have caused large-numbers of lay-offs, while in the cities, poor living conditions have been met with a wave of mass-evictions and forced relocations. And since many of the country's benefits were tied to state employment, a system known as the "iron rice bowl", the run-down of state businesses has brought great social strain. Pensions, for instance, were tied to state companies – and with fewer contributors, the programmes are now under-funded, while employees in newer, private firms find they have little or no coverage. Given the demographic challenges that we will look at in a moment, this poses huge problems for the future. For China's huge migrant labour population, there is no proper welfare system at all. Nor is there any provision for workers in the unofficial economy – the scale of which is hard to judge, but is assumed to be enormous.

95. Yet many in the countryside regard them as the lucky ones. Incomes in rural areas have stagnated, and most people still earn only a dollar or so each day. In the past, there was no pension system for country-dwellers, and the programme that has been unveiled has been universally unpopular, with take-up estimated at around 3%. In addition, farmers increasingly find their land requisitioned for development, with minimal

compensation. More recently, the Chinese Government has begun a policy to help to develop western China, permitting funds to flow from the major state banks to the western provinces. It is already beginning to show results.

96. There is, then, a widening equality gap – and a divergence between the population's approval of their country's success, and dismay at their own share in it. The per capita income in urban areas is three times higher than in rural areas, an exceptionally wide gap when compared with the rest of the world. It is feared that this gap will widen even more unless corrective policies are introduced both in taxation and in such areas as social welfare, education and public health. The government recognises that popular discontent could become a serious challenge to its power: in 2003, the Prime Minister, Wen Jiabao, set out his top priorities as unemployment, regional disparities and rural poverty. But for China, more than any previous Asian 'tiger' economy, it is a race against time.

4.10. *"China will get old before it gets rich"*

97. Demographics play a key role in economic development, with rapid growth often coming at the point where a country combines a young work force with a low number of dependents. This was the case in 19th Europe or post-war Japan, allowing today's great powers to become affluent before they faced aging populations.

98. China has 21% of the world's population, but only 7% of its arable land. The Chinese government therefore has followed a "Family Planning Programme", which internationally has come to be dubbed a "one-child-policy". The aim has been to change the demographic evolution from one characterised by high birth and low mortality rates (and hence a high natural rate of increase) to one of low birth and low mortality rates, leading to a low natural rate of increase. The fertility rate has indeed dropped to 1.8 children per woman - that is, below replacement – with the rate being higher in the countryside than in urban areas. The net increase in China's population is still 10 million per year due to the large population base and the now much lower mortality rate. This is leading to a rapid ageing of the Chinese population, so that by 2040 the country is expected to have a smaller workforce than the United States. The average Chinese person in active age will have two children and four elderly relatives to look after. One government aim is for the Chinese population to peak at 1.6 billion people by 2050, from which point onwards it is expected to remain overall stable or even to decline.

99. China, however, looks set to be the first major developing country to become an aging society before it reaches moderate development. The one-child policy means that its old age dependence is looming remarkably early. In Europe, the "elderly share" of the population was 10% in the 1930s, and will not reach 30% until the 2030s. However it is estimated that China will make such a leap in a single generation, with the elderly population rising from 10% in 2000 and surpassing 30% by 2050. As a result, by 2040, China will have fewer workers, in relation to the number of elderly, than the US – at just about the time when it may be challenging for position as the world's top economy.

100. So those born under the one-child policy will face what economists call the "4-2-1 problem", with one worker supporting 2 parents and 4 grandparents. Also, China's emerging gender imbalance – in a one-child environment, males are more likely to survive - will lead to a shortage of daughters-in-law willing to care for the elderly in the traditional way. (China's ethnic diversity will remain. In the western Yunnan province alone, with its 60 million people, there are over 50 minorities with often widely different languages and religions.)

101. Economists suggest that China will not have sufficient assets to manage the costs of economic transition and honour its pension obligations. The state pension fund, which is already in serious deficit, risks becoming wholly insufficient to meet the needs of the new cohorts of elderly. There is a risk that many older people will in this situation resettle in the countryside, where their material situation is likely to be even more precarious. The government is likely to have to borrow, in order to close the gap, which its low debt levels mean it is well able to do. And so, while the burden of aging need not prevent China's growth, it will change the nature of China's policies – and perhaps it will force a greater degree of attention to welfare.

102. An estimated 140 million Chinese migrate from one part of the country to another each year, a figure which is expected to grow to 200 million per year in a decade. The government sees both positive and negative sides to migration. It offers many people from rural areas new possibilities to develop their skills and improve their career prospects. It increases the labour supply in areas suffering from labour shortages. It can promote urbanisation often seen as needed for economic growth. However, migration may also lead to excessive growth of cities and social suffering. For instance, the city of Chongqing in central China now has an estimated population of 31 million.

103. All in all, these trends underline the precarious nature of contemporary Chinese society. In the short term, of course, the country needs to generate as many jobs as possible. But soon – and more quickly than any of its predecessors - it will need to raise skills and earnings levels. A lot, then, will depend on China's shift from a less productive rural workforce to a more productive urban one.

4.11. *The future lies in the middle*

104. Much – although not all - of the urban population is becoming affluent. And while the world's media abounds with stories of China's new millionaires, it is the growth of the middle-class that will be much more significant. Officially, China aims to create a "well to do" society by 2020, with average income raised to \$5,000 per year (it is \$1,000 today).

105. Somewhere around 300 million Chinese are now thought of as middle class, compared with around 50 million in India. About 70% of urban Chinese households earn between \$2,000 and \$7,500 per year – and since these households tend to be small, they have plenty of disposable income. That means, as retail sales figures have suggested over the last couple of years, that consumption growth is beginning to uncouple from the country's investment level, which will prove important for the long-term health of the economy.

106. This burgeoning, and fairly broad-based middle class is leading a series of lifestyle changes that are familiar to those in the west. Whereas they might previously have lived and worked in the city, employed by a state-owned firm, they are more and more likely to be privately employed and moving out into suburbs. With some access to consumer credit, they will be able to buy a house, and perhaps they will aspire to a car - they are, at least, likely to need one to get to work. Chinese tourists spend more money abroad than those from Japan. China's consumer society is only just getting underway, and despite a rapid boom in sales over recent years, China still has only half the number of cars that the US had at the start of the Great Depression.

107. This group is changing the rules in China's labour market, too. With foreign investment now running at \$1 billion a week, and domestic companies trying to improve staff quality, there are shortages of skilled workers in key cities. With a lack of opportunities for professional qualifications, and few MBA courses available, many graduates start their careers with multinationals so as to get good training, before setting up on their own. And where once foreign firms once complained of Chinese employees' lack of initiative, they now lament the hard bargaining they have to endure in order to recruit and retain good staff. The return of overseas Chinese (known, enchantingly, as "sea turtles") has only accelerated this trend.

108. As a result, management salary levels are increasing by around 10% a year, while inflation is at 2% - and even so, firms such as L'Oreal suffer staff turnover of around 15%. Bonuses and incentives are increasing, too: in a recent survey, a third of multinational companies said they were now offering company cars – and some have even begun to consider outsourcing, to Vietnam or Cambodia.

109. As yet, this situation applies to a small segment of the workforce, and has not impacted on China's growth; but it is an interesting thought that China's swift economic rise may soon be matched by the spread of a "western" labour ethos. It is hard to believe that this new middle class will not, in time, have an impact upon China's politics: and the danger for the party is that the cat – whether black or white – will soon be out of the bag.

4.12. *Can China transform itself?*

110. The implications of all this are complex, and fascinating for western observers. While China's growth is comparable to that of previous Asian tiger economies, the country faces unprecedented challenges of scale and speed. And while it is, perforce, more open than any previous growth economy, the country is still carrying a huge burden in terms of outdated and wasteful industry – which it is wary of abandoning, both for social, cultural and ideological reasons.

111. Judging by recent experience in the region, China is only at an early stage in its development, and it is not unreasonable to expect it to regain some 30% of world economic output by the middle of the century. This may be likely, but can not be taken for granted – there are many “ifs” and “maybes” that could thwart its progress. And for the foreseeable future, most Chinese will be a lot less wealthy than most Europeans.

112. So the answer to the question as to whether China will be able to transform itself is a cautious “yes”. Perhaps the two key factors will be similar to those that applied in the 19th century: first, the nature of outside pressure, given China's new profile in the world. And second, whether China can handle its accelerating social upheaval. Whatever happens, the effect will be felt around the world – and certainly by China's largest trading partner: Europe.

5. **The workshop of an ambivalent world**

113. China's seaboard cities are often called the “workshop of the world”, a title first applied to Britain in the early 19th century. But whereas Britain was the world's leading military force and could compel other countries to trade with it, China operates in a world where military and financial power are in the hands of democracies – which are naturally ambivalent about its rise. And while Britain's industrial base was initially home grown, China relies on foreign business and investment to create the jobs it needs.

114. So China needs cautious diplomacy (and is, of course, inclined to be ambivalent about the outside world itself), but it is driven towards an increasingly assertive trade policy. There is no doubt that China's leaders are sensitive to the dangers – and view with alarm the rise in protectionist sentiment against them. Hand in hand with nationalism at home, they have tried to project themselves abroad as a modern, outward-looking and responsible state. Besides hosting the Olympics, we find China sponsoring nuclear talks with North Korea, albeit uneasily, and offering an unprecedented aid package after the Asian tsunami (the figure increasing daily, at one point, as China competed with Taiwan).

115. Understandably, this approach has met with limited success. In 2003 alone, exports rose by almost 35%, reaching a 6% share in world merchandise exports, the fourth largest in the world, and 2.6% of commercial services exports, the world's ninth-largest. In 2004, exports are thought to have risen by 35% again. China's best hope lies in reciprocal, free trade.

116. For in recent years China has become a vital trade *partner*, for all the world's major economies. On the one hand, companies from all over the world have prospered by locating in China, bringing extra profits to shareholders and better value goods for consumers everywhere. And on the other hand, even as China's exports have increased, imports have been rising even faster.

117. In 2003, China's import level soared by 44% - so that, according to the OECD, the net contribution of foreign trade to Chinese growth was negligible. Thus, its importance to world trade is well above its export share: China has become the third-largest trading nation in the world, on a par with Japan. In 2003, China accounted for 20% of US export growth, 28% of Germany's, and 40% of Korea's. In fact, China may have accounted for a quarter of the world's entire trade growth during that year.

118. In other words, China has become central to world trade – which saw record growth of 9.5% in 2004 - and at least as much because of its imports as because of its exports. So there was a great deal of concern when, in response to fears of overheating, the Chinese government tightened policy. Banking lending was

curbed, interest rates raised, and infrastructure spending was moderated. While the economy appeared to stall in the middle of 2004, it has largely rebounded. And although imports were affected by the government's measures, they still grew by 36%, a little faster than exports.

119. Last year's concerns demonstrate that any derailment of Chinese growth will have a substantial knock-on effect – especially if it were unable to keep funding the US deficits. And there would be a major impact on more open economies, particularly those in Asia. (Thailand is already known as the "Oriental Detroit", because of the quantity of components it supplies to China's car industry).

120. But if slow Chinese growth is one concern, accelerating growth is another. Developments in 2005 have prompted a fierce reaction in the US, which has long been exposed to high levels of Chinese imports. But they have also stirred a reaction in Europe, which had previously had a much more positive policy outlook.

121. To attempt to reach a balanced view of the current situation and its prospects, we need to examine all sides of the trading relationship with China. For as we shall see, it is not at all clear that the west's prevailing reaction, combining popular fear and political recrimination, is correct in the circumstances.

5.1. *Investment and trade: the west looks to China*

122. China has been widely criticised for flooding the developed world with cheap goods. But, as we have seen, foreign investment is largely making this rise in expertise and capacity possible. Five countries – the US, UK, Germany, Japan and France – account for more than half of foreign investment, with most of the rest coming from China's neighbours, notably Hong Kong.

123. The US experienced large-scale Chinese imports earlier than Europe, both because of higher US investment in the country, and because that investment has been more targeted toward businesses that make cheap consumer goods. Wal-Mart Stores, for instance, imported \$12 billion of goods from China in 2004. Europe's distribution systems are traditionally more fragmented – and individual countries tend to have traditional suppliers, often former colonies - and this has, so far, served to maintain a greater diversity of supply.

124. Europe's trade relationship with China has been remarkably healthy, and increasingly important to both sides. In 2004 China remained the European Union's second biggest trading partner (after the US) and, according to Chinese statistics, became China's top trading partner (ahead of the US and Japan). But whereas the EU had a trade surplus with China during the 1980s, there is now a widening trade deficit (around 80 billion euros in 2004). This is now the EU's biggest bilateral trade deficit.

125. But that figure conceals the underlying strength of the relationship. Europe is, overall, an export-focussed economy: the eurozone, for instance, has a trade surplus with the outside world, in stark contrast to the US. And during the first 10 months of 2004, EU countries sold \$41 billion in goods and services to China, nearly twice the amount of US exports. For while Europe is mainly importing low-cost items, such as toys, that it no longer manufactures in quantity, the continent excels at the sort of high-quality goods that are in demand in China. As we have seen, there is a huge appetite for infrastructure equipment, a traditional strength for European companies. Siemens has been heavily involved in upgrading the Chinese telecommunications system, while selling equipment for dams, power plants, and railways. ABB supplies the Chinese steel and petrochemical industries, while French utility companies Suez and Veolia Environnement have won billions in contracts for water and waste-treatment systems.

126. Given the scale of China's infrastructure challenge, there should be plenty of scope for this type of trade to prosper. Alongside construction and transport, environmental and biotech expertise are likely to be increasingly important, and as Dirk Schumacher, an economist at Goldman Sachs, says: "The demand we're seeing in China is nothing that will fade away immediately."

127. While it is true that some of China's more ambitious projects have been delayed in the attempt to prevent the economy overheating, the government has no option but to continue spending – not least as Beijing prepares to host the Olympics. A high-speed rail line to Shanghai, a project second in cost only to the

Three Gorges Dam, is currently the subject of a contest between Alstom, Siemens and Japan's Shinkansen. The Association of German Chambers of Commerce & Industry predicts that German exports to China will rise 20% annually for the foreseeable future, and Chancellor Schröder has led five trade missions to China.

128. Perhaps the most outstanding example of Europe's export success in China is Airbus. Until the mid-1980s Boeing dominated China's airline market; but today, there are 270 Airbus planes in service there, 32% of the entire fleet – and last year, two-thirds of the new planes delivered in China came from Airbus. The company is now in an excellent position, in a market where spending is projected to reach \$200 billion over the next 20 years.

129. To achieve this, Airbus has invested heavily in China; it has built a flight-training school near Beijing, and offers free instruction to customers. It has also launched a local engineering and design centre, and China was named as the company's partner in developing the A350. Like Boeing, the company subcontracts work to Chinese plants, and the new A380 super-jumbo has been designed with Chinese passenger volumes in mind. Its first Chinese order was secured earlier this year, and the company is hopeful that China will prove to be the airliner's number one market.

130. As this example suggests, Europe's trade with China, and its investment in China, are becoming indivisible. And one can see European products appear in local form, in sectors as diverse as cars and make-up. Today, a European visitor might be surprised by the number of familiar cars on China's streets – for Volkswagen's operation is the country's market leader, and groups such as Mercedes and Peugeot-Citroen are also strongly represented. Although the car market's recent boom has been slowed by credit-tightening, and as in many sectors short-term profits are hard to come by, the major manufacturers are committed to long-term investment. Volkswagen plans to spend \$7.6 billion to increase production over the next four years.

131. In virtually every sector of Chinese business, the west's major companies are competing against each other to build long-term market share. Carrefour, Tesco and Walmart are partnered with the largest supermarket stores; Accor, Best Western, Marriott and Intercontinental race to create hotel accommodation, while Procter and Gamble and Unilever do battle in the toiletries sector. L'Oréal, too, has three cosmetics factories in China, and reports that sales in China grew 69% last year. Meanwhile, accountants, management consultants, and financial services groups have been quick to move in – and Europe's expertise in these areas should prove lucrative, as China attempts to modernise its welfare systems and adjust to its aging demography

132. And with rising affluence, luxury commodities have begun to flourish. Morgan Stanley estimates that the number of Chinese able to buy luxury goods will rise from 13 million to 100 million by 2010. Western brands such as Prada, Louis Vuitton and Ermenegildo Zegna have opened stores across China's cities. There has been a dramatic resurgence in wine drinking, too (some think that wine originated in Western China), providing an export bonanza – and now, as the domestic industry booms, French growers are developing new Chinese vineyards. Remy Cointreau has recently taken a 25% stake in Dynasty Wines, one of the largest producers.

133. This taste for European style and culture is highly visible. Architects are in high demand, and there is a craze for building opera houses - with London's Zaha Hadid designing one in Guangzhou, and France's Paul Andreu responsible for another in Shanghai, and still another located on Tiananmen Square itself. He has also designed the new Shanghai Airport, which is another sector of great promise for the west.

134. As Airbus has discovered, the air travel market is in full-scale expansion, and the number of airports in China has doubled in a decade, to more than 130. China is forecast to be the second largest air market in the world in five years, and as the sector has begun to be liberalised, several European companies have taken stakes in airport groups. Moreover, China is predicted to be the largest source of international travellers by 2007, and recent visa agreements have made it easier for Chinese tourists to visit Europe. Already, there are 1 million visitors annually, and it is thought that this number will, at least, triple. Europe has also become an increasingly popular destination for language training, higher education and work experience, as US immigration requirements have become more rigorous. 300 million Chinese are said to be interested in learning, or improving, their English!

5.2. *What about the threat to jobs?*

135. Thousands of western companies now rely on production from China so as to remain competitive. Walmart and IKEA were pioneers in this, as were sportswear makers such as Adidas, Puma, and Geox – a company that now manufactures in China for domestic sales, where it can charge as much as it does in the west – and there's no doubt that the trend is increasingly widespread. A recent survey suggests that almost half of all British manufacturers are considering transferring some capacity. And even a luxury brand such as Villeroy & Boch, based in the heart of Europe and with centuries of tradition, is sourcing new production in China.

136. All the same, "the idea that that the world's manufacturing industry is going to move to China is crazy," says Bill Emmott, the editor of *The Economist*. He points out that factors such as exchange rate movements, product differentials, skill levels, and the need to be close to markets will always play in huge role in production. And in Europe's case, it's worth noting that a great deal of relocation has happened already – much of it within the continent. Increasingly, low-cost manufacturing has moved southwards and eastwards: most televisions sold in Europe, for instance, are now made in Turkey, and companies such as Renault and Peugeot have been quietly developing factories in Poland and Hungary. While this has benefited Europe's competitiveness, and its consumers, it has also put Europe's social models under great pressure. There is an increasing trend of maintaining old European production facilities, and allowing them to decline by gradual natural wastage, while creating new capacity elsewhere. For employment, this will have a "time bomb" effect, which can be handled but cannot be avoided.

137. So it may be the less-developed economies, in and around Europe, that face the most severe impact from China. But their location and their relatively flexible labour force are likely to help them retain business – and interestingly, should help them to win investment from China itself (especially with China's growth raising shipping costs). For instance, China Display Digital Imaging Technology, a Shanghai-based maker of televisions, is considering some production in Eastern Europe, to reduce transport and customs expenses, while Hong Kong-based investment adviser Victor Chu is setting up a fund to invest in Chinese-Turkish joint ventures.

138. Having said all this, 2005 has so far proved a rude awakening for the western world. China's export surge, coupled with its domestic slowdown, has had a dramatic effect. Comparing figures for the first two months of the year, Germany saw a trade surplus of \$1.24 billion last year turn into a deficit of \$316 million. And Italy, which last year had a deficit of \$256 million, is now in deficit by \$812 million. Why?

139. "A lot of this is the cumulative effect of foreign multinationals building up their Chinese production facilities," says Stephen Roach, the chief economist at Morgan Stanley. "After years of investment, it's all coming together big time."

140. Indeed, much of this effect is caused by switched production – of computers and electronics, in particular – away from former production sites in Japan or Asia. So, while this exacerbates Europe's headline deficit with China, it is not in fact costing Europe much production. But there is one sector where export growth has been enormous, and where both Europe and the US have reacted vigorously: textiles.

141. Until this year, in the regulated environment of the multi-fibre agreement, Europe has been the world's largest exporter of textiles. And although the sector has been in long-term decline, with employment falling by 60% in the last decade, it still accounts for two million European jobs. But with this year's expiration of the agreement, Chinese textile exports began to rise – not completely without restriction, and from a low starting level, but more freely than before. For instance, according to the European Union, T-shirt imports rose by more than 150%, while sweater and trouser imports increased by more than 400%.

142. Within weeks, there was an outcry on both sides of the Atlantic, and reports of massive job-losses were soon being published in the media. In Washington, quota levels were simply imposed, while in Europe, an attempt was made to negotiate. By May, a new agreement was in place, limiting import growth in ten key sectors to 10% a year until 2008, so as to provide European industry with a breathing space (and the reports of mass closures immediately disappeared). Then, in the summer of 2005 the EU blocked its imports of

garments from China. The EU action was taken after certain member countries protested that their textile industry was perishing due to the new competition, with other EU members complaining that their retailers were hurting due to lost sales. A compromise was eventually found with China.

143. Europe's politicians are to be congratulated on achieving an agreed solution – given the popular reaction, they had little choice but to intervene - and the industry might reasonably expect support in adapting to new circumstances. All the same, the multi-fibre agreement has been in force since the 1970s, and its expiration date was known to all - so how did this panic happen? Europe's breathing space has clearly not been agreed in the interests of consumers: by July, sweater imports had already reached their quota level, and been suspended. Moreover, unless industry acts vigorously, it will be counter-productive to them, too. China's textile industry is traditionally fragmented - but having fruitlessly geared up for greater exports, firms are now forced to consolidate and try to add more value to their products. In three years time, European textiles will face much stiffer competition.

144. The Chinese may not be greatly surprised by all this – but they should be forgiven a degree of exasperation; under its WTO agreement, China is being driven to liberalise its markets – but until 2013, any other country may restrict Chinese imports if they have a disruptive effect. During the textile negotiations, China's minister wearily said: "China will protect its own legitimate rights, and on the other hand will act in line with WTO regulations." He hinted, at the same time, that China would now slow the opening of its markets to agricultural products. It seems that China is beginning to understand the west!

145. Europe's textile industry will inevitably contract – as it was doing in any case - but it is capable of finding new ways to prosper, if it makes good use of its breathing space. Beppe Pisani, an Italian textile producer, has already felt the pressure. "We Italians went into China early," he says, "we brought them our methods, we sold them our machinery – and now it is like having a grown-up child who doesn't need you anymore." But his company has responded by importing silk and synthetics from China, and applying traditional Italian finishing techniques. He's even selling some of the finished textiles back to Chinese customers. As the managing director of Prada, Patrizio Bertelli, says: "To attempt to put up tariffs against Chinese imports to Europe would be as useless as building another Great Wall".

146. In fact, Chinese imports seem, to the public, more substantial than they are, because they are concentrated in consumer items, which are far more visible than more-lucrative industrial supplies and equipment. Last year, for instance, clothing accounted for only about 6 percent of US imports - while industrial supplies and equipment accounted for 55 percent. And overall, it is developed countries that supply about half of US manufactured imports, while all the developing countries of Asia put together account for less than 10%. And this is not surprising since, according to the International Labour Organisation, there remains an enormous productivity gap: a Chinese manufacturing worker supplies only 8% of the added-value that an American worker does. Put another way, this means that it takes 12 Chinese workers to equal one American. Where skills and productivity count, the developed countries still retain a manufacturing advantage.

147. China's car industry suggests how that situation is evolving. This summer, the first Chinese car imports have arrived in Europe. The Landwind, made by the Jiangling Company, is a 4x4 SUV, available for less than 18,000 euros – and although only 2,000 sales are expected this year, it marks an interesting shift in strategy. Jiangling, which is 30% owned by Ford, produces only 50,000 vehicles at home, But with domestic sales having slowed, and large amounts of cheap, state-provided capital pushing production upward, China's car makers are in search of a market. Chery Automotive has announced plans to export up to 250,000 cars to the US within two years – although analysts say that its production capacity is just 80,000 vehicles. Meanwhile, Brilliance - one of China's biggest car companies - is upgrading its four-door saloon, so as to sell it in Europe within two years.

148. Like the glut in steel production referred to earlier, this supposed surge in exports seems to be more a sign of China's confused investment strategy than its industrial prowess. Perhaps, in the longer term, China will be able to emulate Japan, and develop cars that can succeed in western markets. Price will certainly be an advantage: Chery's M14 convertible - designed with the Italian coachbuilder Pininfarina - is expected to sell for about 15,000 euros, 30% cheaper than most of its rivals.

149. China is an important trade partner for Europe and the West, as a market for our exports, and a source of investment returns. In cars, as in other sectors, it is foreign skills and investment that are pushing China's growth. European industry begins with a skills and productivity advantage that, at least in part, offsets higher labour costs. But that advantage cannot be eternal. The challenge to our product and labour markets from rising Chinese exports clearly needs to be addressed – but through long-term structural reform rather than short-term protectionist measures.

150. Europe will have to continue to innovate, adapt, and reduce costs – as it has been doing for hundreds of years. And if it does so, European business has bright prospects – for China's own companies are by no means ready to take over the world.

5.3. *The Chinese are coming!*

151. The US congress has reacted with alarm to recent attempts by Chinese companies to purchase American brands – and there has been media comment about the dangers of major corporate takeovers, inspired and funded by a communist government. But in fact, the "Going Global" policy has been received with enthusiasm by many countries, and it's notable that even some OECD members are now lobbying for Chinese investment. Ironically, the policy is in part driven by China's wish to find a use for all the dollars they have been buying, but there are several other reasons – which tend to emphasise China's weakness, rather than her strength.

152. To take two examples: last year's sale of Thomson's television business to TCL, and the sale of IBM's PC division to Lenovo; both were excellent value for the sellers. Both were restrictive deals, which left out lucrative parts of the operation, and where the purchasers gave up sizeable stakes in the new enterprise. In effect, the Chinese have had to gamble, by taking over moribund if well-known western brands. If they fail to turn them around, the sellers will have disposed of the businesses profitably; but if they succeed, the sellers will share in the rewards.

153. Interestingly, Taiwanese firms are able to negotiate much better deals – as the recent BenQ take-over of Siemens mobile phone division demonstrates. In that case, Siemens is paying € 250 million to get the company off its hands, is transferring all patent rights, and must also pay to take a stake in the new business. The main reason for this is that Taiwan's companies have hard-earned strengths that translate into real competitive advantage – while China's big manufacturing companies are trading groups that have prospered by selling ultra-cheap versions of desirable electronic items when most Chinese could not afford more expensive foreign models.

154. As China's markets liberalise and as consumers grow richer, these companies find that they do not have the research and development expertise that has driven the growth of Japan or Korea, nor the manufacturing efficiency that characterises Taiwan, and therefore cannot build quality brands. Their overseas purchases are an attempt to get around this, but their bargaining position is therefore not strong.

155. This year's battle for control of MG Rover (between two Chinese companies!) makes the point clearly. Although loss-making since 1994, regarded as a hopeless case in Europe, and rebuffed in its attempts to find partners in every other corner of the car-making world, Rover's brands and technology are thought attractive in China. Some, at least, of Rover's laid-off workers should have cause to be grateful for this, and we may expect to see a similar story in other failing western companies. If Rover's story is any guide, China's acquisition goals will be more of an opportunity than a threat, for some time to come.

5.4. *Economic needs and political insecurities*

156. The reaction to the prospect of Chinese corporate takeovers may be disproportionate, but it is understandable. For there is a fundamental unease amongst the world's developed countries about China's form of government, and uncertainty as to how much of a threat it represents. For the first time in modern history, a major, totalitarian regime is growing in power because of the buying decisions of free people, and thereby becoming a lynchpin of world trade.

157. It is therefore worth looking at some of the main potential causes of diplomatic tension and disagreement:

- For China, there is no higher priority than securing its future energy needs – and it is determined not to have to rely upon the west. With its own rise, and that of other developing countries, high demand levels are here to stay, and supply will become a more and more pressing issue. Inevitably, this is causing tensions, as China seeks to gain energy extraction technology, and lays claim to nearby resources. China is currently squabbling with Japan over which country will receive an oil pipeline from Siberia, and disputing the ownership of a stretch of ocean where oil is thought to be located. This year, Japan has been particularly alarmed at what it sees as official encouragement of violent demonstrations against its interests.
- In its search for energy supplies, China is also looking farther afield. It is increasingly involved with the oil industries of countries such as Venezuela, and Cuba, Iran and Sudan. This has raised fears of a worldwide bidding war for resources. And while Chinese arms exports have declined over the last twenty years, there is evidence that arms deals have been linked to oil supply investment. Zimbabwe, a country with rich mineral resources, is also a recipient of Chinese aid and weaponry – and on a recent visit to Beijing, President Mugabe was described as “a trusted old friend”.
- Human rights groups accuse China of using its position on the UN Security Council to shield its new allies – and in particular, of being instrumental in blocking attempts to deal effectively with the crisis in Darfur. They cite, too, China’s suppression of human rights at home, and its occupation of Tibet. With no great change likely on China’s part, these issues will continue to cloud relations with the west.
- Washington now sees China as one of the countries most responsible for weapons technology transfer, and proliferation. Recent increases in military spending mean, they say, that China has the third largest defence budget in the world (after Russia and the US) – although it is still only around a fifth of the US budget. The Chinese military was reduced in size during the 1980s, but its historic role as protector of party rule guaranteed its status, and after Tiananmen Square it regained influence. Today, the army numbers around 1.6 million men. Observers have seen the subsequent hawkish stance toward Taiwan, and massive naval exercises in the Taiwan Strait, as responses to military pressure – and despite renewed efforts to reduce the military’s political role, Taiwan’s own moves (partly as party posturing) toward formal independence seem likely to help maintain their prestige and resources. A recent Pentagon report on China warns that there is considerable investment being made towards being able to fight a high-intensity, close-proximity war – but accepts that China’s long-range military capability is limited.
- Against this background, there is a continuing debate about lifting the embargo on advanced weapons sales to China, though both Europe and the US sell lower-technology equipment, such as jeeps and helicopters. Many European countries are in favour of doing so and an EU initiative to this end was heralded in the spring of 2005, but in the face of strong US opposition, the subject is currently put on ice.
- And although it is little mentioned, China is known to be engaged in widespread espionage in western countries, particularly targeting high technology companies. A recent defector in Belgium identified a network of industrial spies operating throughout Europe. It has been reported, too, that one large European company was led to involve China as a partner in a recent satellite project, when it discovered that the Chinese had already learned everything there was to know about it!

158. There are, then, plenty of sources for disagreement – and there is an understandable background tension between China and the US, most recently seen in China’s joining the call for an American troop withdrawal from Central Asia. But all sides seem to realise that conflict would be in no one’s interests – and even in the case of Taiwan, it still seems more than possible that diplomacy will, in time, resolve the issue. As was the case in Tiananmen Square, conflict is likely to come only because of miscalculation.

159. This raises an interesting, and sensitive, question. While China has now joined the WTO, it is not a member of other important bodies, such as the OECD, that have democratic criteria. (Donald Johnston, the outgoing OECD Secretary General, in an interview with the Financial Times in July 2005 indeed suggested Chinese membership, arguing that "you cannot exclude a country that could become the biggest economy in the world".) Nor has China been invited to join the G8 "club" of leading nations - although Russia, a much smaller economy, has. Yet China's economy is already larger than most of the club's members, and in the not too distant future, it may be the largest in the world. If China and the west have not been able to accommodate each other by then, what will the G8 be?

160. This embarrassing situation underlines the west's discomfort with China's rise. But clearly, in the next few years, we will have to alter our assumptions about the values of the modern economic world, or persuade China to think about it more in the way we do.

6. Europe and China: the odd (and still matching) couple

161. At first sight, Europe and China are as different from each other as they could be. Europe's labour market is costly and regulated, its growth is relatively sluggish, and consumer confidence is, at best, patchy. Furthermore, democracy is widespread, social programmes are relatively strong - and even in Europe's less prosperous countries, average earnings are well ahead of China's. As the OECD has pointed out, the eurozone and China are, economically, counter-cyclical.

162. But this odd couple have become integral trading partners - and there is more connecting them than may at first appear. Both have ancient cultures and traditions, a long history of trading success, and both have economies oriented toward exporting. And while China's export strength is based upon of low-costs and high-volumes, Europe increasingly specialises in value-added goods. Moreover, both face the challenge of an aging population.

163. For many reasons, as we have seen, China will not be the disaster for Europe's economy that some have predicted. Yet there are plenty of lessons to be drawn. Here are some suggestions:

- Size matters - the impact of China's rise has been, fundamentally, a question of scale, and reaffirms the vision of Europe's post-war founding fathers. Europe will need to be as united and cohesive as possible, if it is to respond. The world's great powers are, increasingly, *big* powers. We have seen this in recent trade negotiations, where Europe as a whole has had substantial bargaining power, and we have seen it in commerce, where large enterprises such as Airbus have had the capacity to beat global competition, and service an immense market.
- Globalisation is here to stay - without foreign investment, China would not be where it is today. That has happened in the context of a world in which the stock of foreign investment has increased ten-fold in twenty years. Although large, China is only the latest developing country to grow in this way - India is just behind, with a population that will outstrip China's in a generation. For businesses in Europe, as everywhere else, constantly raising productivity and constantly lowering costs will remain a way of life. And Europeans will earn more and more of their wealth from investment overseas.
- The price of raw materials is likely to stay high - the world's demand for energy (and other finite materials) will only increase. Europe is already an energy-efficient continent, but it will need to go further. It will also have a huge commercial opportunity, by marketing clean and efficient technology. And when it comes to major environmental challenges, it is clear that these will not be overcome by the efforts we are making alone - on global warming, for instance, neither China nor India (nor, of course, the US) is part of the Kyoto Accord. We will need new, outward-looking solutions. (China is not party to the Kyoto Protocol to reduce climate change but nevertheless says it wants to abide by it.)

- China's growth has driven the expansion of world trade – despite high oil prices, trade is at record levels, and China is a key part of that success. As well as China, other developing countries will continue to force the pace of global growth: at least, we should hope that they will, for this is bringing about unprecedented wealth in the developed world. A failing China is more likely to harm trade and living standards in Europe, and worldwide, than a successful one.
- Protectionism is bound to fail. In such a multilateral world, with its complex trading system, protectionism will rebound on whoever introduces it. While some of China's exports are artificially cheap, this is true of certain exports from the developed world, too, such as subsidised agricultural commodities. We should beware of panic based upon astonishing statistics, and maintain a broader view of the quality of mutual trade. Our aim should be to use our position, to encourage China to remove distortions and to open access to its markets – especially in terms of allowing foreign firms to increase their shareholdings and ensuring that remaining tariffs are scrapped. We can hardly advocate this credibly, if we seek to keep our own markets closed, and attempt to prevent Chinese take-overs. As China's commerce minister has pointed out, to buy one Airbus super-jumbo, China needs to sell 800 million shirts. We need to keep buying China's shirts. Chinese investors meanwhile seem to aim for more than just exports. Since the bulk of profits in a foreign market stand to be made, not through exports, but through control of distribution channels and even more so retailing, this is where Chinese acquisitions and investments are likely concentrate in the future.
- Europe's strengths are in high demand – besides high-value products, Europe's well-developed service industries, educational infrastructure and cultural prowess give the continent an edge in trade with China, including in tourism where millions of increasingly wealthy Chinese are likely to include Europe in their itinerary. With a more comprehensive social model than the US, we have much to offer China in terms of updating its financial services, introducing social and pension programmes, and in healthcare (which is already the biggest industry in the world, and will soon be immense in China). Unfortunately, much of Europe's activity is fragmented and regulated, so that the US retains a considerable competitive advantage. If we could overcome this, Europe's social expertise could turn out to be a blueprint for the world.
- Europe is good at making the most of opportunity – our history is built upon the ability to adapt and change. Unquestionably, China's rise is a challenge to us, and should shape our continent's policies for the next generation. In particular, we need to shift the structure of employment, creating new jobs in new sectors (and most of all in services), and our industries need to capitalise on their skills and productivity strengths. This is, in fact, an acceleration of a process that Europe has been engaged in for fifty years, and which has yielded a huge increase in living standards for ordinary Europeans. We should not forget that the average European, in whatever part of Europe he or she lives, remains incomparably wealthier than the average Chinese – and is likely to remain so, for the foreseeable future.
- China's success is not a thing to fear, but to hope for – the UN reports that economic growth in China and India has been the biggest factor in helping to approach the world's Millennium Development Goals. Certainly, it has far outstripped the achievements of the developed world's aid budgets. We should wish this history-making process to continue. If China fails, it will not prevent the influx of low-cost goods into the developed world, but it will set back the cause of poverty reduction by a generation. If China succeeds, it will have brought about an astonishing improvement in the lives of one-fifth of the world's population – and it will, very likely, have transformed the society they live in.

- Europe's values matter – some have predicted that the new “Asian Century” will see the eclipse of Europe's values. But clearly, that is far from the case. China's system is under relentless pressure from a lack of personal freedom and social justice, and just as its economic development is in its early stages, so is its political progress. Europe can be proud, and confident, of its long-standing ideals – which demand that we support the hopes and aspirations of China's people. This could - in fact it should - be a European Century, too, and what organisation could better contribute to this than our Council of Europe, whose work to strengthen democracy, human rights and the rule of law inside and beyond Europe is as vital as ever. China's presence in Strasbourg through a Consul General, who indeed recently held a much appreciated exchange of views with our Economic Committee on the Chinese economy, is a sign that China values a dialogue on these and other matters with our organisation.

7. Concluding remarks

164. Will the rise of China be the story of our age? One way or another, it probably will. The government of China – and therefore, like it or not, the people of China – are running tremendous risks with their country's expansion. Though the pattern is a familiar resurgence of an Asian economy, it has never before been attempted on such a scale, and from such an impoverished starting point. Much has been achieved, but there are severe problems – many of which, as we have seen, are institutional. So far, the prize has been a huge improvement in the lives of many people, and the promise that it will soon apply to many more – and yet there remains the risk of an economic or social collapse.

165. Europe will not want to see this project fail. That is not in the interest of the people of China, nor is it in the interests – or true to the values – of the peoples of Europe. In the short term, we will want to see the Chinese currency able to trade in the market, we will continue to advocate the reduction of tariffs and other barriers to trade, and we will, of course, need to manage the economic impact of trade through negotiation with China.

166. China is likely not to hesitate to use its military to defend its own interests. We must hope, and do our utmost to ensure, that it will not do this in a way that will endanger regional or world peace. As far as European sales of weapons to China are concerned, it is this Rapporteur's opinion that Europe should be able to do so, though with conditions to ensure that they are not used for purposes of which we do not approve. If we do not lift the weapons embargo in the way the European Union suggested in early 2005 before the initiative was abandoned due to US pressure, we can expect Chinese industrial espionage to continue and links to be established with dubious regimes for the purpose of buying weapons.

167. Some countries have managed to move up economically under authoritarian regimes: Germany, Japan, South Korea, and the Soviet Union spring to mind. But none has stayed in the front rank without moving toward democracy. Leadership demands innovation, after all, and democracy is the most efficient way to supply it, as our Economic Committee and the Parliamentary Assembly never tires of emphasizing. Currently, China is the only economic power without democratic credentials, and the great question is whether it can acquire them, without coming apart. If it can, the prospects for peace and stability in the 21st century look good. If not, we risk a return of looming tension over the “China threat”.

168. Much depends on China's success or otherwise in dealing with its own contradictions - and the less confident it is at home, the more nationalist is its foreign policy likely to be. But the democratic world has a contribution to make, too – and perhaps Europe's present crisis of identity, and our sense of who we are and what our future might be, can even be resolved by our engagement with China. Moreover, as Peter Mendelssohn, the EU's trade commissioner, has said: “If you treat China as an enemy, then it is likely to become one.”

169. The west's relationship with China, then, will be crucial. If it is successful, we will have created a model for the rich world that can accommodate more of the planet. But to achieve this, the west, and not just China, will have to embrace change. Hopefully we will do so - at this relatively early stage in China's resurgence - and not waste our opportunity, as the textile industry largely has, and as China's embattled elite did when confronted by Europe in the last century.

170. Confucius (without whom no paper on China could end) put this thought elegantly: "By three methods we may learn wisdom: first by reflection, which is noblest; second by imitation, which is easiest; and third by experience, which is the bitterest."

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Members of the Committee: Mr Evgeni **Kirilov** (Chairperson), Mrs Antigoni Pericleous Papadopoulos (Vice-Chairperson), Mr Márton Braun (Vice-Chairperson), Mr Konstantinos Vrettos (Vice-Chairperson), MM. Ruhi **Açikgöz**, Ulrich Adam, Hans Ager, Abdülkadir Ateş, Radu-Mircea **Berceanu**, Akhmed Bilalov, Jaime Blanco (alternate: Mme Elvira **Cortajarena**), Patrick Breen, Milos Budin (Andrea **Rigoni**), Erol Aslan **Cebeci**, Mrs Ingrida Circene, MM. Ignacio Cosidó, Giovanni **Crema**, Øystein Djupedal, Ioannis Dragassakis, Iván Farkas, Joan Albert Farré Santuré, Relu Fenechiu, Mrs Siv Fridleifsdóttir, MM. Carles Gasóliba, Francis Grignon, Alfred Gusenbauer, Nick Harvey, Norbert Hauptert, Anders G. **Högmark**, Ivan Ivanov, Klaus Werner Jonas, Ms Verica Kalanović MM. Karen Karapetyan, Orest Klympush, Anatoliy **Korobeynikov**, Rudolf Kraus, Zoran Krstevski, Jean-Marie Le Guen, Harald Leibrecht, Rune Lund, Gadzhzy Makhachev (alternate: Mrs Liudmila **Pirozhnikova**), David Marshall, Jean-Pierre Masseret, Miloš **Melčák**, José Mendes Bota, Mrs Ljiljana Milićević, MM. Neven **Mimica**, Gebhard **Negele**, Conny **Öhman**, Guilherme de Oliveira Martins, Mart Opmann, Bogdan Podgórski, Jakob Presečnik, Jeffrey Pullicino Orlando, Luigi Ramponi, Maurizio Rattini, Maximilian Reimann (Alternate: Johannes **Randegger**), Dario Rivolta, Volodymyr Rybak, Kimmo **Sasi**, Bernard Schreiner, Samad Seyidov, Leonid Slutsky, Ms Geraldine Smith, Mrs Aynur Sofiyeva, MM. Christophe Spiliotis-Saquet, Qazim Tepshi, Frans Timmermans, Dragan Todorović, Mrs Ágnes Vadai, Mr Luc Van den Brande, Mrs Jelleke Veenendaal, Mrs Birutė **Vėsaitė**, MM. Oldřich **Vojíš**, Varujan Vosganian, Robert Walter, Andrzej Wielowieyski, Marek **Wikiński**, Paul **Wille**, Mrs Rosmarie **Zapfl-Helbling**, Mr Kostyantyn Zhevago.

N.B: The names of the members who took part in the meeting are printed in bold

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