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Reassessing China: Awaiting Xi Jinping

In the Hu Jintao era (2002–2012) China's politics, economics, and national security policies have changed almost beyond recognition. The ongoing transformation has been largely obscured by images that dominate many Western minds: Manichean democrats see a jasmine revolution waiting to happen; hedge fund managers see a gigantic bubble waiting to burst; national security executives see China as having perfected an enduring, dynamic state capitalism with Leninist political management that threatens to overwhelm us. These contradictory images share one thing: lacking roots in Chinese reality, they project the hopes and fears of their respective believers. Two decades ago, when writing *The Rise of China*, I could confidently predict Chinese success based on Deng Xiaoping's emulation of similar policies in South Korea and Taiwan.[1] After three decades of that success, China's future is far less certain today.

China's New Politics

From 1978 through 2002, China's leaders (Deng Xiaoping, Hu Yaobang, Zhao Ziyang, Zhu Rongji, and Jiang Zemin) were charismatic, entrepreneurial, decisive, and risk-taking. They thought big thoughts, made big changes, and took great risks. Sometimes they lost big (Hu Yaobang and Zhao Ziyang) and sometimes they won big (Deng Xiaoping, Jiang Zemin, and Zhu Rongji), but it was always big. Beginning in 2003, China shifted from charismatic to institutionalized leadership. Today's leaders are administrators, risk-averse, incremental, pragmatic, unemotional, and colorless.

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Their predecessors were China's cosmopolitans. Deng Xiaoping was the leader who, unlike Mao, had spent formative years abroad, in France. Jiang Zemin and Zhu Rongji had their core career experiences in Shanghai, China's most cosmopolitan, relatively market-oriented city. In contrast, Hu Jintao and Wen Jiabao, with core experiences in Tibet and Gansu, represent the localist reaction against Shanghai-style globalization. They speak for the equivalent of Michigan's resentment of New York-style globalization, competition, stress, and inequality.

The years prior to 2002 saw central power strengthen. In 1990, Beijing could not control the money supply, nor could the prime minister easily fire an important governor or transfer an important regional commanding general. The central government could not collect taxes effectively. By the end of the Jiang–Zhu period at the beginning of 2003, it could do all these things. Since 2003, however, interest groups—including large state enterprises, the military, and the provinces—as well as netizens and citizen groups willing to stage demonstrations, have greatly enhanced their influence. Beijing's top leaders constantly find themselves on the defensive.

One cause of rising interest group influence is the current leaders' need to gather support to get their allies into positions of power for an uncertain transition in 2012. Previous reform-era presidents and prime ministers were designated by Deng Xiaoping, and the succession was clear. Even in 2002, Deng ruled from the grave as his choice for top leader, Hu Jintao, was honored. The choices for the decade starting in 2012 are the first in three decades not controlled by Deng, and the resulting uncertainty has incited struggle, not for the top job but for control of the Politburo Standing Committee, the Military Committee, the State Council, and the Central Committee.

This new leadership style and power distribution also reflects deeper trends. Deng, Jiang, and Zhu drew support from a population traumatized by Mao's Cultural Revolution, fearful of imminent financial collapse, and wounded by more than a century of division and impoverishment. They tried great things because anything less would entail certain failure and because the sense of crisis mustered popular support for tough decisions. Today's leaders govern incrementally because they can, and because dissipation of the sense of national urgency has depleted public support for stressful change.

The new power of interest groups has led not just to administrative incrementalism but also to fearful curtailment of both economic and political reform. Political reform was very rapid from 1978 through 2002, transforming China from a country ruled by the contradictory personal whims of Mao to one ruled through institutions and rules. In the process, freedoms blossomed, affecting everything from clothing to haircuts to job or marital choices to social and political speech. Totalitarianism changed into authoritarianism. Similarly, the market progressed and the private economy seemed to be gathering momentum to overtake the state enterprise economy in the manner of Taiwan's transformation. Since 2002, however, rapid political and economic reforms have largely ceased and sometimes partially reversed.

> Today's Chinese leaders are administrators, risk-averse, incremental, and pragmatic.

The social backgrounds of the leaders are also changing. Until recently, there were severe restrictions on the roles of the offspring of China's great revolutionary leaders (known in China as princelings). Now, the princelings will dominate the Politburo and the Central Committee, which is to say that they will rule China.

With this change comes a transformation of popular political attitudes. While earlier top leaders obtained support for tough measures from a scared population, by the last 18 months of the Jiang–Zhu era, the populace was weary from the stress of marketization and globalization and deeply resentful of Zhu. In response, Hu Jintao appeared, promising a "harmonious society" without the stresses of the Zhu era.[2] In contrast, Hu will leave behind resentment that he failed to push forward on economic and political reform. The advent of the princelings brings to power a leadership team whose position derives from political inheritance and wealth rather than heroic transformational leadership. Popular resentment of what is seen as the arrogance of the emerging political and financial elite is already high and will create serious problems unless the new leaders deliver some kind of decisive improvements.

What the new leaders will do remains a great enigma. Xi Jinping, who is assumed to be the next party leader and president, has been extremely cautious about articulating his opinions in order to ensure that his path to the top job does not lead off a cliff. But unlike his predecessors, he has the confidence that comes from being a princeling and from having some military background. (Hu's opponents have clubbed Hu mercilessly, albeit unfairly, for alleged weakness on national security issues.) On the other hand, Xi will take office at a time when pressures to resume political reform are so widespread that even Prime Minister Wen's calls for democratization have to be censored. Below Xi will be leaders who do have ambitious and outspoken agendas, such as Li Yuanchao's image of China leading the world through a globalization of talent and others' determination to show that socialism can work. Their visions are partially

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inconsistent and the tensions between those visions could be either creatively dynamic or immobilizing.

To be clear, this is not a polity vulnerable to revolution like, for instance, Egypt's. In half a century, Chinese life expectancy has risen from the low 40s to 73, and since 1979 all major social groups have increased their real incomes by at least 600 percent. Unlike in India, the roads get built and the children get educated. Even before the Western financial crisis, the Pew surveys revealed that China stood first in the world in satisfaction with national conditions (72 percent), with the United States tenth (39 percent).[3] But neither is it a country that has found an equilibrium in Leninist state capitalism. The most fundamental structures are changing fast. The mood in Beijing is one of profound impatience over the reform hiatus.

China's New Economy

China's economy in the 1990s was dominated by a desperate effort to avoid financial collapse, with the banks dragged down by money-losing state enterprises. Now, China has four of the world's ten largest banks and the big state enterprises are obscenely profitable. Zhu Rongji's successful effort to save the banks by imposing market discipline or selling off their state enterprise customers saw 50 million state enterprise jobs and 25 million manufacturing jobs lost in a decade. Growing out of these problems and reducing poverty seemed to justify growth at any cost to the environment and social fairness.

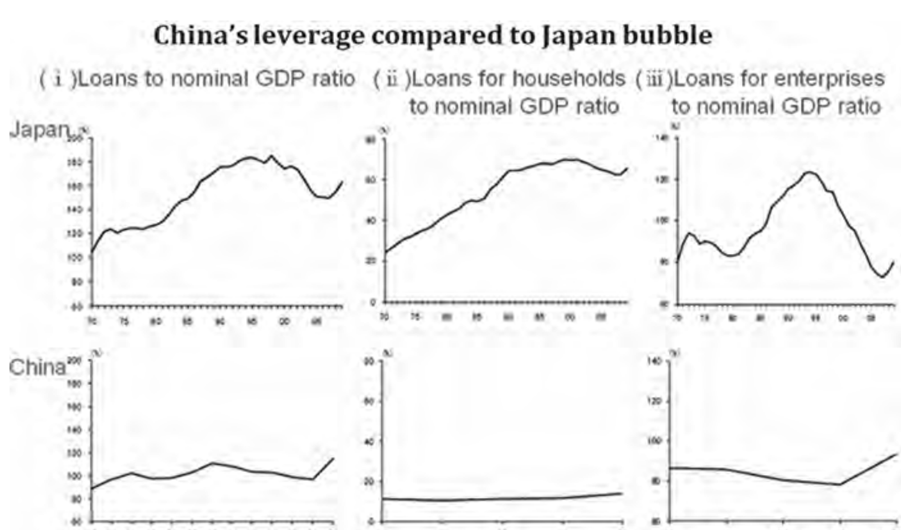
In contrast, current leaders have implemented an amazingly successful effort to bring growth to the formerly neglected interior, and their concern about the environment has left Western leaders fearful that China will seize leadership across the range of green technologies. Replacing the collapsed social safety net of the old communes with modern pension systems, medical insurance, and social security programs has become a priority. The military, starved until the mid-1990s, is making up for lost time. Whereas the priority of the 1990s was marketization, in order to curtail the losses of the state enterprises, during the global financial crisis the current leaders discovered the value of state-owned banks and state enterprises in managing a crisis. Even after the crisis, they have continued to emphasize the value of the state enterprises, which benefit from implicit credit guarantees, below market interest rates, little taxation, and negligible pressure to pay dividends. Meanwhile, the smaller and private enterprises, which had previously expanded in a manner reminiscent of

Taiwan a generation earlier, are being crippled by a lack of credit. Market reforms have become as dormant as political reforms.

A decade ago, China seemed to have a limitless reservoir of cheap labor. In perhaps the single most transformative economic change of recent years, Chinese industry now faces labor *shortages*, particularly of skilled labor. The 12th Five-Year Plan calls for the "minimum wage to increase by no less than 13 percent annually"[4] and export industry wages are rising at a much faster rate.[5] The emerging labor shortage, food supply chain issues, and the hangover from the massive stimulus that got the country through the financial crisis have left China with problems of inflation, property price inflation, and imminent bank problems.

Having said that, China is not at risk of a Japan- or U.S.-scale bubble. As Figure 1 shows, Chinese leverage is far less than what occurred in Japan. Chinese housing prices are not that far out of line with other major Asian cities, its mortgages require a minimum 30 percent down payment, and a high proportion of properties are still sold for cash. Chinese central government public debt was only 16.3 percent of GDP in 2011.[6] If the government absorbed all the local debt, total central government debt would still be only 60 percent of GDP, far below typical U.S. and EU indebtedness.[7]

Figure 1.



Source: China Banking Reform Commission data, graphic from Kumiko Okazaki, Masazumi Hattori and Wataru Takahashi, "The Challenges Confronting the Banking System Reform in China: An Analysis in Light of Japan's Experience of Financial Liberalization," *Institute of Monetary and Economic Studies Discussion Paper Series 2011-E-6*, March 2011.

Having said this, China's successful management of the financial crisis obscured its deeper structural problems. By 2007–2008, China was experiencing a paradoxical combination of rapidly rising inflation and rapidly-multiplying bankruptcies. This combination signaled the equivalent of a Jimmy Carter moment—a time when the economy needed profound structural changes, not just fiscal and monetary tinkering. China's success was making obsolete the two great drivers of its previous economic success. Investments in infrastructure had once focused primarily on enormously productive projects like building the first superhighway between Beijing and Shanghai; now, they increasingly build wasteful large shopping malls in small cities. Most of the infrastructure has been financed by re-zoning agricultural land and selling it at very high prices, a process that is reaching its limits as property prices come off their peak and people protest expropriation of their land. Similarly, the explosive growth of exports based on cheap labor was exhausting both the cheap labor and the willingness of foreign markets to absorb more Chinese exports. China needed new drivers.

The obvious solution was a vast shift to higher-value consumption products directed primarily at the domestic market, a vast expansion of the service sector and of mass housing, and a shift of manufacturing away from state enterprises and heavy industry to more innovative small, medium, and private enterprises. Instead, the financial crisis highlighted the ability of state-owned banks and state-owned enterprises to ramp up production and jobs quickly in order to offset the crisis. The global crisis itself discredited—erroneously—the model of marketization that had enthralled previous Chinese leaders. The result was encapsulated in a slogan, "The state advances and the private sector retreats."[8] That slogan, and the financial policies that are perpetuating it, raise serious questions about where China's future jobs and innovation will come from. Everywhere in the world, giant enterprises eventually shrink employment and prove weak at fundamental innovation. By 2011, the paradox of simultaneous inflation and a serious squeeze on small and medium enterprises had returned. China's economy is now like a school of fish where the big fish are very energetic (generating 8–10 percent GDP growth) because they are eating the small fish. But eating the small fish endangers the future.

The Chinese administration does not intend to kill off its smaller and private enterprises, and in fact, has important programs to support them. Indeed, along with other supports, in December 2011 it approved a massive infusion of funds into the small and medium enterprise (SME) sector, along with preferences for procurement from SMEs and reduction of their taxes and fees.[9] However, that infusion is too little, very late, ad hoc, and unlikely to be dispensed efficiently. Prior to the late 2011 stimulus program, China's financial system had left the overwhelming majority of SMEs in financial distress. This is because it controls inflation not mainly through interest rates, but primarily by forcing the banks to hold extremely high reserves (21 percent). So the banks cut off all but their best customers, the big state enterprises, which get money at state-controlled interest rates (6.5 percent) that until recently roughly equaled the rate of inflation. They in turn use that essentially free money to take over all sectors and to speculate.

Hence, the paradox of speculative inflation and widespread bankruptcy: the smaller enterprises typically pay rates from 25 percent up to 400 percent, and as a result many thousands are dying.[10] If the government would move forward on reform, freeing interest rates and using them to control inflation, the economy would be more balanced, there would be more innovation and jobs in the future, speculation would be reduced, and a major source of political dissatisfaction would decline. But the socialist instincts of the current administration have so far prevented this.

Another noteworthy cost of the reform hiatus has been an explosion of corruption. In all emerging economies, graft is omnipresent, but major policies under Jiang Zemin and Zhu Rongji limited it. The late 1990s saw a huge emphasis on enhancing competition in the major state-dominated sectors of the economy, great expansion of more competitive smaller businesses, drastic cutbacks of military enterprises, halving government employment complemented by quadrupling salaries, and slashing regulations. All these structurally curtailed corruption. In the past decade, however, government employment has nearly doubled, the availability of effectively free money from the banks has meant that political influence translates directly into wealth, competition in the state and private sectors has weakened, foreign direct investment has been more restricted, and the involvement of senior military officers in business has once again flourished. The most sincere police campaigns cannot offset the weakening structural impediments to corruption. It is important not to exaggerate this, however. China has one of the world's most effective government management systems, and many aspects of that management have improved under Hu and Wen. But the trend of corruption is sharply in the wrong direction, and that worsens public discontent.

At the deepest level, economic management under Hu Jintao and Wen Jiabao reflects the structural shift in Chinese politics. Deng, Jiang, and Zhu were obsessed with efficient growth at all cost because they feared China faced collapse. The Asian economic miracles are products of fear: Japan after wartime defeat, South Korea after the Korean War, Taiwan after Chiang Kai-shek's defeat, and Singapore confronting larger neighbors. When fear subsides, normal politics resumes. The Hu–Wen decision to eschew fundamental reforms in favor of the status quo has its political parallel in the Obama–Boehner and Merkel–Sarkozy decisions to play politics as normal with debt crises, rather than embrace painful but necessary decisions. While normal, this marks a decisive shift in Chinese economic management and raises questions about whether, and how, China's swift rise will continue.

The common view that China has found the formula for dynamic state capitalism is risible.

Hu Jintao's administration demonstrated tactical brilliance in rescuing the economy from the global financial crisis. Its success in developing China's interior has been astonishing. It has consolidated a remarkable government administrative system that manages China as if it were General Electric. But it has failed to address the strategic dilemma of simultaneous high inflation and high bankruptcy that appeared in 2006–2007 and has reappeared in 2011. That failure worsens the emerging disconnect in Chinese politics. "The state advances and the private sector retreats" translates politically into resentment of the power and arrogance of giant institutions and their well-connected, often fabulously-wealthy bosses. Now that hubris is beginning to replace the earlier sense of crisis, the interest groups and localities no longer suffer gladly the domination of a social elite underwritten by preferential policies.

Given all these changes, the common Western national security managers' view of a China that has found the formula for a permanently dynamic Leninist state capitalism is risible. Chinese leaders' view of their situation is far more balanced—a developing country managing rapid change. Although reform has stalled recently, one of the strengths of Chinese leadership has been that it contained no Brezhnevs, Chernenkos, or Andropovs who believed that their country had already created a permanent, satisfactory structure.

What of the hedge fund managers who see a Japanese or U.S.-style bubble? China certainly has significant challenges in managing inflation, property prices, and looming bank problems, but the bubble problems are generally exaggerated. The *acute* problem of bubbles is serious, and will likely slow the economy substantially for a time, but hardly fatal. Focus on the bubble problems has tended to obscure the chronic need for reinvigorated reform if China is to maintain dynamic growth.

China's New Geopolitics

The Western world has been startled by China's apparent new geopolitical posture in 2010 and 2011. (But read further before making firm judgments about how much of the change actually results from new assertiveness on the part of the Chinese government.) Seemingly overnight, China has evolved from a country with a lack of confidence to one laced with hubris, from the old slogan of "never lead" to an assertive foreign policy. Instead of protesting mildly over important arms sales to Taiwan, Beijing turned Obama's first innocuous arms sales in 2010 into a crisis. Whereas it once settled most of its land borders to the satisfaction of the other party, now it confronts virtually all of its ocean neighbors in asserting its "indisputable sovereignty," sometimes with military force.[11] Where it used to be flexible in discussing North Korea, it has become rigid.

Whereas the Obama administration took office at a time of widespread American belief in the possibility of wide ranging U.S.–Chinese cooperation (symbolized in the phrase G-2), and Obama proffered such a relationship in his first meeting with Hu Jintao, by 2011 most American commentators believed that China had emphatically rejected such mutual cooperation in favor of an assertive policy at the expense of the interests of the United States and China's coastal neighbors. China's relationships have declined with Japan because of a hyper-reaction to the Japanese arrest of a Chinese fishing boat in September 2010, with South Korea because China blocked all but minimal international responses to North Korean attacks, with the United States *inter alia* because of Beijing's huge reaction to innocuous U.S. arms sales, with ASEAN countries because of greater assertiveness over sovereignty claims in the South China Sea, with the foreign business community because of a grab for foreign companies' technologies and restrictions on rare earth exports, and with Australia and the European Union (as well as the United States) because of an overall combination of these factors. In 18 months from July 2009–December 2010, China lost many of the benefits of two decades of friendship diplomacy.

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This startling shift in diplomatic relationships had multiple causes. China's success was replacing fear and overcautiousness with confidence and assertion. The Western financial crisis and subsequent mismanagement in the United States and the European Union punctured the image of Western managerial superiority, and the contrast between U.S.–EU mismanagement and Chinese–Indian–Brazilian growth seemed to many, not just in China, to presage an accelerating attenuation of three centuries of Western dominance. Unlike China, the U.S. and German polities seemed incapable of rising above petty politics in a crisis. China's regional military capability had reached a threshold where its increasingly modern air, naval, and missile capabilities could potentially impose politically unacceptable costs on a U.S. naval effort to control the seas near China in a conflict. Moreover, notwithstanding loud assertions to the contrary in Washington about a pivot to Asia,[12] the U.S. budget mismanagement entails an eventual end to U.S. military hegemony along the beaches of China.

As with Japan a generation ago, simultaneously alongside emerging big power hubris, a small-country mentality continues to pervade Chinese policy. A sense of big power obligation to invest in maintaining a stable international system—helping inhibit nuclear proliferation by Iran, helping curtail international financial imbalances, helping ensure that North Korean attacks on South Korea are unprofitable—lags behind the assertion of China's new big power prerogatives.

The most important reasons for the shift lie in Chinese domestic politics. From the beginning, the Hu administration has been vulnerable to assertions by factional opponents that its leaders lacked military experience and national security toughness. In a succession campaign, this naturally leads to overcompensation. Rising interest-group influence transformed the management of foreign policy. Powerful enterprises and individuals increasingly won protection of their interests. The coastal exporters overwhelmed the national interest in using stronger currency appreciation to move manufacturing industry up-market, to shift the basis of growth toward domestic consumption, to control inflation, and to curtail the senseless accumulation of trillions of dollars of loss-making foreign currency reserves. Military and public security officers resumed flaunting their wealth in a way that Jiang Zemin had curtailed.

As the 2012–2013 succession approached, leaders' fear of losing the support of key domestic political allies overwhelmed policy discipline. Nowhere was this more evident than in the assertion by a few officers and officials that dominance of the South China Sea was a "core interest" alongside Taiwan and Tibet. An army of Chinese diplomats and academics spread the message that this was not national policy, but top leaders refrained from openly contradicting potential allies in the competition for post-2012 power. This perfectly mirrored the demagoguery about China that occurs in U.S. presidential campaigns (including 2012), but it was far more consequential because the world was not accustomed to Chinese policy indiscipline. Senior retired officers promised that policy discipline would be reinstated after the transition, but that remains to be seen.

One senior Chinese officer said to the author, "For decades, you Americans have told us that we just have to understand that the Pentagon has one foreign policy, the State Department another, the White House another, and the Congress and the media some more. Now we are becoming more like you. Deal with it."[13] Most national security conversations in Washington still operate on the implicit assumption that, if one or two prominent Chinese assert a policy stance, for instance about "core interests," that constitutes an authoritative articulation of an agreed policy. Not so, any more than it does in Washington.

The new Chinese stance also responds to a decade of stored-up grievances. Under George W. Bush, the United States sought to restore Japan as the pivot of all U.S. Asia policy, and to press Japan into a more active military role, just as Japan fell under the (fortunately brief) sway of right-wing nationalist Japanese administrations that were determined to keep China down and sponsor the rewriting of history to say, *inter alia*, that China and the United States were responsible for World War II. Working with one such administration, in February 2005, the United States explicitly brought Taiwan under the purview of the U.S.–Japan alliance. For the first time, the United States promised to defend the disputed Senkaku–Diaoyu Islands as an alliance obligation. The United States, Japan, India, and Australia held four-power naval exercises, which the United States disingenuously denied to be directed at China but which Japan trumpeted as an aspect of mobilizing countries with common values against opponents (i.e., China). The United States gave India a free ride on border conflicts, claims of a right to dominate large parts of the world's oceans, investments in Sudan, deals with Iran, claims to be a great power, and much else, while severely criticizing China for similar or sometimes (particularly on border issues) much milder behavior.

In particular, the United States encouraged Indian ambitions in the South China Sea, where New Delhi has negligible legitimate interests, while criticizing China's claims. In the South China Sea, where all claimants have pursued exaggerated and dishonest claims, the United States chose to criticize only China. Nowhere was this more blatant than in the case of drilling for oil and gas: a 2002 agreement pledged China and ASEAN countries to joint development in the disputed areas while shelving sovereignty disputes. According to Chinese figures, ASEAN countries subsequently drilled more than 1,000 wells in disregard of the understanding, while China drilled none, but when China reasserted its claims, the United States treated China as the only party behaving inappropriately.[14]

Most importantly, the U.S. Navy and Air Force conduct a continuous intense intelligence-gathering campaign with ships and aircraft along the Chinese coast, monitoring Chinese communications and military movements. These missions include simulated attacks on important locations along the coast, designed to trigger Chinese defenses and allow the United States to understand every aspect of Chinese responses to a military situation. China has responded by occasionally harassing these missions and by insisting that the UN Convention on the Law of the Sea gives it the right to exclude such military operations in its exclusive economic zone—an interpretation that is a) consistent with the wording of the law; b) inconsistent with the original intent of the drafters; and c) strongly supported by other countries such as India and Brazil, which would regard this kind of U.S. behavior along their coasts as intolerable. The U.S. military has treated Chinese resistance to U.S. intelligence gathering and simulated attacks as aggressive, and U.S. media have generally reported only the U.S. military viewpoint.

Chinese island and territorial waters claims are certainly excessive—as are, proportionately, the claims of Vietnam, the Philippines, Malaysia, Taiwan and India. At the same time, U.S. military actions are clearly inconsistent with the acknowledgment by all recent presidents that, if we treat China as an enemy, then we ensure that it will be an enemy, so we should be careful not to do that. If the Chinese Navy and Air Force were closely monitoring U.S. communications from 12 miles off our coast, and running simulated attacks at Washington, our leaders would treat it as something close to an act of war. Excessive Chinese claims and excessively antagonistic U.S. military policies have locked the two countries into a spiral that risks cold war. On both sides, domestic political games are worsening the conflicts. China's claims risk permanently alienating a majority of its smaller neighbors. U.S. naval aggressiveness risks turning much of the world against our interpretation of the law of the seas.

Whither China?

The certainty expressed about China's future by Manichean democrats, hedge fund bubble detectors, and national security predictors of permanently dynamic Leninist state capitalism fails to capture the range of possible outcomes for China's uncertain future. The worst scenario for China is a diluted version of Japan's gradual decay. Japan after 1955 was a typical mobilization system: frightened by defeat in war, the country unified (despite opposition parties and noisy dissidents) around a dominant party's determination to build the economy at whatever cost was required. The ruling Liberal Democratic Party (LDP) had such dominance of political funding and organizational capability that it could force through whatever policies were necessary. The LDP, government ministries, and leading businesses were strongly allied. Half of government revenues were off-budget, beyond democratic scrutiny. Corrupt funding from many sectors ensured LDP electoral dominance. The government's wartime-style ability to channel the policies of banks and major corporations through administrative guidance gave the LDP the ability to shape the economy.

Japan reached out all over the world for best practices. It gradually marketized much of its economy. As the economy developed and markets changed, it proactively forced adjustments—for instance, forcing the aluminum industry offshore after rising energy costs made it unprofitable at home, or accepting and even promoting a gradual shift overseas of industries like basic textiles which had become obsolete at home. A determined nation embraced whatever would speed recovery.

After 1975, complacency replaced urgency. Interest-group power dominated the legislature, which became divided into "tribes" (*zuko* in Japanese). Whereas building the roads and bullet trains had once driven Japan's rapid growth, now the power of the construction lobby led to unproductively building highways, trains, and bridges to nowhere, paving nearly every streambed and river bottom. Many industries arranged for protection, often in subtle forms, against domestic and foreign competition. The big conglomerates so completely dominated the economy that the creativity of smaller companies was stifled. Instead of acknowledging globalized best practices as the key to success, Japanese politicians convinced themselves that their success flowed from unique Japanese cultural practices. (Ironically, the practices in question were in fact copied from the prewar mobilizations of Germany and the Soviet Union, not from ancient Japanese culture.) Japanese leaders became confident that Asia would lead the world, and Japan would lead Asia. As Japan turned inward, growth slowed and productivity declined. The financial crisis of 1990 was just a punctuation mark on an economy that has flatlined ever since. By 2015, Japanese living standards will be surpassed by South Korea, which has all of Japan's problems and fewer advantages, but has been more successful at the transition to a fully competitive polity and economy.[15]

China exhibits some signs of the Japan syndrome: premature hubris, emergent interest group power, an increasing predominance of the interests of the party–government–big company triangle over national economic interests, and snuffing small-company dynamism. Without resuming reform, it will suffer some of the same gradual loss of dynamism. Because China is much more open to both domestic and international competition than Japan, and continues to promote globalization, a Chinese decay scenario would be economically less severe than what Japan has suffered. But it would occur at a much lower level of income, technology, and political development, so the social and political consequences would be *more* severe.

While a gradual Japanese-style decay is the worst case scenario, the best case would catapult China into global leadership. Visionary reformists (see the writings of Wang Huiyao)[16] envision China as a successor to British and U.S. leadership through globalization. The first phase of globalization was industry, led by Britain, resulting in the British Empire. The second phase was finance, led by the United States, resulting in a half century of U.S. dominance. The third phase is globalization of talent and that, if China's reformers have their way, will be led by China. This process is well under way. All Chinese must take seven years of English to graduate from high school. From its airline regulation to its stock market regulation to its bank credit management, China has been emulating best foreign

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practice and often importing high-level foreign talent to implement the new ways. Nearly all Chinese elite families have children or grandchildren in U.S. Ivy League universities, and numerous Chinese vice ministers spend a semester at Harvard to ensure their understanding of global best practice. Seventy-eight percent of Chinese university presidents have their Ph.D. degrees from foreign institutions, as do 72 percent of research lab heads. China has 150 entrepreneurial parks for returnees from abroad who want to start businesses.[17]

This determined emulation of global best practice is the core secret of Chinese success so far. But as the reformers understand, to go from here to global leadership requires transformational reforms. Today, 82 percent of Chinese students in the United States choose to remain in the United States, contributing primarily to America's economy rather than to China's. To get them back, to attract the most talented Europeans and Americans, and to get the benefits of all that talent, China must provide an attractive and fertile environment for them. That means a legal, financial, and intellectual property system which facilitates their success. That requires financial-system reform based on market interest rates rather than bank reserve ratios and administrative guidance of lending. It requires taking away the special privileges of the state enterprises by withdrawing privileged access to the banks and making them pay appropriate taxes, interest rates, and dividends. It means full access to the Internet and freedom to express controversial views. In short, it requires a vigorous resumption of the market and political reforms that were underway in the 1990s.

Some of this positive scenario will happen. Many of the globalization initiatives have already been approved and partially implemented. But, given the scale of Chinese society, the extreme form of globalization of talent, exemplified by Singapore, is impossible. Moreover, the resumption of market and political reforms will be fiercely resisted by many of the expanded central government, local government, military, princeling, and state enterprise interest groups that have become so empowered in recent years.

Just as China's superior openness and commitment to globalization mean that it will avoid the worst of the Japanese-decay scenario, the vast empowerment of conservative interests that has occurred since 2003 means that the full aspirations of those who seek world leadership through globalization of talent will not be fully achieved. But those constraints leave a vast range of possible outcomes, ranging from gradual loss of momentum to gradual replacement of U.S. world leadership, depending on the leaders who ascend in 2012–2013.

China's succession struggle is not just about who will rule, but about the future character of the Chinese nation.

> **What the new leaders will do remains a great enigma.**

At the beginning of the Hu–Wen administration, I likened China to a man being chased by a tiger.[18] If one focuses a camera on the man, one is awed by how fast he runs; surely he can outdistance anyone else. If, however, the camera focuses on the tiger (problems of environment, urbanization, inequality, political demands, etc.), one concludes that anything in front of that tiger will get eaten. Under Jiang Zemin and Zhu Rongji, the man far outdistanced the tiger, but then tired and needed a nap. Since then, while giving Hu Jintao and Wen Jiabao full credit for historic achievements in developing the interior, overcoming the global financial crisis, developing world class public administration systems, and initiating environmental improvement programs, the nap of economic and political reform has persisted so long that the tiger is catching up. We are about to discover whether the tiger's approach will reveal prolonged Chinese lethargy or stimulate a new round of reforms that catapult China to world leadership.

Notes

1. William H. Overholt, *The Rise of China: How Economic Reform is Creating a New Superpower* (New York: W.W. Norton, 1993). For a recent statement of the parallels between China and the other "miracle economies," see William H. Overholt, "The China Model," *Fudan Journal of the Humanities & Social Sciences* 5, no. 2 (June, 2011).
2. Along with "scientific development," the concept of "harmonious society" has been the key slogan of the Hu Jintao era. It encompasses harmony between man and environment, between social classes, and between China and foreign countries. Implicit in the concept of harmonious society is a repudiation of the Mao-era emphasis on class struggle as the key dynamic of politics. Implicit also is a move away from the degree of social stress and inequality entailed by the frenetic market reforms of the Zhu Rongji era. For an officially endorsed definition, see "Harmonious Society," *People's Daily* report on the 17th National Congress of the Communist Party of China, September 29, 2007, http://english.people.com.cn/90002/92169/92211/6274603.html.
3. Pew Global Attitudes Project, "China's Optimism," table on "Satisfaction with National Conditions," November 16, 2005, http://www.pewglobal.org/2005/11/16/chinas-optimism/.
4. For instance, see "Key targets of China's 12th five-year plan," *Xinhua*, March 5, 2011, http://news.xinhuanet.com/english2010/china/2011-03/05/c_13762230.htm.
5. The most commonly cited study of actual wages is a KPMG study that is not publicly available, but the KPMG website contains an overview by an outside author: James Anderlini, "Has China Reached Its Peak?" originally published in *High Growth Markets*, April 2011, http://www.kpmg.com/US/en/WhatWeDo/Industries/Japanese-Practice/Pages/2011-issue2-article1.aspx. In October 2011, China's Ministry of Human Re-

sources and Social Security stated that the minimum wage in 21 of 31 provinces had risen by an average of 21.7 percent in the first nine months of 2011 alone. See, for instance, Li Mao, "21 Regions Across China Raise Minimum Wage," *People's Daily Online*, October 26, 2011, http://english.peopledaily.com.cn/90882/7626697.html.

6. See *CIA World Factbook*, https://www.cia.gov/library/publications/the-world-factbook/fields/2186.html.
7. One of the most careful studies of local debt is provided by two papers by Ting Lu and T.J. Bond, "LGFV and Local Government Debt: This time is not that different," Bank of America Merrill Lynch, April 8, 2010, and "LGFV: The sub-prime trap for China?" Bank of America Merrill Lynch, March 22, 2010.
8. The saying became omnipresent. For instance, the Brookings Institution held a seminar, "China's New Breed of State Capitalism," with the theme "Known popularly in China as *guojin mintui* or 'the state advances and the private sector retreats,' this apparent enhancement of state monopolies has in recent months been fiercely debated in Beijing." See http://www.brookings.edu/events/2011/0301_china_capitalism.aspx.
9. See, for instance, "China announces support for SMEs in government purchasing," *Xinhua*, December 31, 2011, http://news.xinhuanet.com/english/china/2011-12/31/c_131337773.htm.
10. The numbers on interest rates commonly paid by SMEs are from conversations with Chinese business executives. A high proportion of those loans are technically illegal, so they are not openly quoted. On the difficulties of the SMEs, see "SMEs headed for collapse, business lobby warns," *China Economic Review*, July 22, 2011, http://www.chinaeconomicreview.com/content/smes-headed-collapse-business-lobby-warns; and "China's SMEs face adverse conditions in 2011," *Xinhua*, September 1, 2011, http://news.xinhuanet.com/english2010/china/2011-09/01/c_131092442.htm.
11. See, for instance, "China reiterates its 'indisputable sovereignty' over Diaoyu Islands," *Xinhua*, January 3, 2012, http://news.xinhuanet.com/english/china/2012-01/03/c_131340503.htm; and "China Says Its South Sea Claims Are 'Indisputable'," *Bloomberg News*, July 30, 2010, http://www.bloomberg.com/news/2010-07-30/china-has-indisputable-sovereignty-in-south-china-sea-defense-aide-says.html.
12. The pivot to Asia has become the principal buzz phrase for U.S. national security policy in Asia. See, for instance, Hillary Clinton, "America's Pacific Century," *Foreign Policy*, November 2011, http://www.foreignpolicy.com/articles/2011/10/11/americas_pacific_century; Barack Obama, "Remarks By President Obama to the Australian Parliament," The White House, November 17, 2011, http://www.whitehouse.gov/the-press-office/2011/11/17/remarks-president-obama-australian-parliament; and Barack Obama, "Remarks by the President on the Defense Strategic Review," The White House, January 5, 2012, http://www.whitehouse.gov/the-press-office/2012/01/05/remarks-presi-president-defense-strategic-review.
13. Author interview, May 2011. I was not given permission to name the individual.
14. Author interview with Tung Chee-hwa, vice-chairman of the 11th National Committee of the Chinese People's Political Consultative Conference (CPPCC), July 1, 2011.
15. For calculations that indicate South Korea's likely surpassing of Japanese average wages, see "Flying Geese No More," *The Oriental Economist* 78, no. 11 (November 2010).
16. Most of Wang Huiyao's work is available only in Chinese (several books) and in his numerous oral/PowerPoint presentations. Some of his English-language work is available on the Brookings Institution website. See, for instance, "China's National Talent Plan: Key Measures and Objectives," http://www.brookings.edu/~/media/Files/rc/papers/2010/1123_china_talent_wang/1123_china_talent_wang.pdf.

17. These figures and the subsequent figure about Chinese students remaining in the United States are taken from oral/PowerPoint presentations by Wang Huiyao at Harvard in 2010 and at Yale in 2011. He is the author of several books in Chinese on related topics.
18. William H. Overholt, "China's Economy, Resilience and Challenge," *Harvard China Review*, Spring 2004, http://www.rand.org/content/dam/rand/pubs/reprints/2005/RP1116.pdf.