



Skyline watching in Shanghai. In only 35 years, “an impoverished totalitarian Communist state” has grown to the second largest economy in the world, poised to overtake the United States within a decade. Flickr photo

# Where is China Heading? —A Letter from Ditchley Park

Kevin Lynch

*While China’s growth has long been a quarterly fixation of markets and analysts—both political and economic—we rarely focus on its long-term prospects beyond betting on when it will surpass the United States as the world’s largest economy. How will China maintain strong growth and social stability while meeting the evolving demands of an expanding middle class? BMO Financial Group Vice-Chair and former Privy Council Clerk Kevin Lynch shares his thoughts on China’s future, fresh from Ditchley Park.*

Given the importance of China to the global economy today, it is useful to pause and ponder where China will be a decade from now, rather than just focusing on its next-quarter GDP numbers.

To set an historical context, consider the following thought experiment: it is 1980 and a distinguished group of Western economists and policy advisers are asked to rate the chances that China, an impoverished, totalitarian Communist state just emerging from

the cultural revolution, will go on a 35-year growth binge that would make it the second-largest economy in the world, a global economic power eclipsing all but the United States. Their answer would have been unanimous, and utterly incorrect. This is a useful reminder as the world considers the path China might follow over the next decade or so, at a time when it is facing an exceedingly complex array of policy problems and “China skeptics” again abound in Western policy circles.

At a recent high-level Ditchley Conference in the UK where leading economic and political experts attempted to peer into China’s future, there was a fair consensus—but certainly not unanimity—that:

- continuation of strong economic growth without significant policy reforms is unlikely;
- political reforms are probably not a prerequisite for the needed policy reforms, given China’s track record and the policy skills of today’s leadership cadre, but being able to affect the required reforms is an open question; and
- pressures for a more responsive political model—possibly “responsive authoritarianism” but not a Western-style democracy, would likely grow, but major changes are unlikely before the next generation of Communist Party leadership.

Reflecting on this political-versus-policy reform debate recently, Francis Fukuyama has argued: “An effective political system has to balance state capacity against rule of law and democracy. I think in the United States and certain other democratic countries, the emphasis has been so much on the constraint of state power that we end up not being able to make difficult decisions. But I think China is the opposite, and that’s not a good situation either.”

Clearly, China’s rapid economic growth has been one of the key features of the “new global normal.” It

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will surpass the US within a decade as the world’s largest economy and it is already the world’s largest energy consumer. China has become the mass manufacturing hub of the world. This incredible pace of economic growth has lifted over half a billion Chinese out of abject poverty and created a new middle class that numbers hundreds of millions and continues to grow rapidly. Private enterprise is expanding robustly, and an entrepreneurial spirit is taking hold among young educated Chinese, as they look to Jack Ma and Alibaba, rather than government, for career inspiration. China has built world class infrastructure in many areas (compare La Guardia to the Beijing airport for example), is developing a globally credible university system with internationally competitive research, and is producing a bilingual crop of future business and government leaders. And it has done this while maintaining a relatively low ratio of federal government debt to GDP, building a relatively high level of foreign reserves, reining in inflation, and integrating hundreds of millions of people from the countryside into the cities in the largest migration in human history.

This success, astonishing for its scale and timeframe, is not without its challenges. Environmental degradation has been enormous, led by air pollution (visit Beijing in winter), water shortages (11 ‘dry provinces’) and widespread water quality problems. Corruption is problematic (witness the extraordinary anti-corruptive drive of President Xi Jinping), and a legal system geared to the rule *by* law, not the rule *of* law does not give the certainty that private sector investors seek. Ex-

cessive reliance on export-led growth imbalances the economy, and immature systems for pensions, healthcare, and unemployment insurance, make excessive personal savings logical but economically inefficient.

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Labor, land and capital markets have lagged goods markets in China’s policy liberalization, and have led to property asset bubbles, excessive local government debt and decreasing competitiveness. Demographics will soon become a drag rather than a motor of growth, and productivity growth and innovation will have to be dramatically increased if China is to sustain its high rates of economic growth and raise living standards further. Finally, income inequality is both high and rising, and may become a front burner issue if China is to avoid “the middle-income development trap.”

Outside China, the need for political reform within China is widely discussed, with the typical argument being that some kind of political change seems inevitable as a prosperous middle class develops and wants more say over how they are governed and more protec-



Chinese President Xi Jinping meets with Gen. Martin Dempsey, chief of the US Joint Chiefs of Staff, in Beijing. As Kevin Lynch writes: “China intends to be more a rule maker, not just a rule taker, in the shifting geopolitical order.” DOD photo, Flickr

tions—the rule of law not rule by law. Inside China, not surprisingly, the debate is more muted as the Communist Party’s main focus is maintaining its legitimacy, preserving “social harmony”, and guarding its dominant position. Indeed, the current anti-corruption campaign is publicly popular, enhancing the party’s legitimacy, and clearly consolidates the party leadership’s power.

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The Chinese people tend to evaluate their present by reference to their past, not surprising for a nation with 5,000 years of history. With respect to the West, it is the “hundred years of humiliation” narrative; with respect to strong leadership, it is never forgetting past periods of instability and chaos; with respect to rules and authority,

it is the reality that bureaucracy was a Chinese invention to bind together a far-flung empire by more than arbitrary behaviours. But, with respect to representative bodies, there is no Chinese historical reference point, unlike the West with its Roman and Greek antecedents. A key question, given the need for substantial policy change to sustain robust growth, is whether current Chinese governance structures are an impediment to policy change or capable of leading such change? And, the jury is still out on whether reforms will be deep and fast enough given the shifting dynamics in the Chinese economy.

The most immediate challenge is that of growth, which is giving every indication of slowing below the government’s new target of seven per cent, despite Chinese government assurances to the contrary. The pertinent questions are not whether but why there will be a growth shortfall and how much it will be. On the “why”, I believe the slowdown is more structural than cyclical—reflecting aging demographics and low productivity (excess capacity, little innovation, capital market rigidities)—and these structural factors combine with the consumption impacts of the anti-corruption campaign and local property bubbles to magnify the growth weakness. On the “how much”, the IMF

has marked China’s growth down to 6¾ per cent in 2015, and somewhat weaker next year, with risks still to the downside. The recent gyrations in Chinese stock markets, the frenzied measures to prop up equity prices and the decision to devalue the currency only underscore the growth challenges facing Chinese policy makers.

Supporting the structural view of slowing growth is President Xi himself. In recent speeches he refers to “the new normal” for China, calls for rebalancing Chinese growth towards consumption and services and away from exports, advocates an innovation agenda to raise Chinese productivity and improve competitiveness and is moving ahead with financial sector reform, albeit with Chinese characteristics. In this regard, the government has approved a growing number of offshore renminbi clearing centres (15 and counting), including Canada, to support the increasing international role of the Chinese currency. Reform of State Owned Enterprises (SOEs) was a core feature of the 3rd Plenum, although details are scarce and outright privatizations of major SOEs unlikely. However, there is a growing appreciation that a too-dominant SOE position in the economy is an impediment to innovation and productivity. As someone noted, the rise of Alibaba required both the

extraordinary entrepreneurship of Jack Ma and the absence of an SOE in the e-commerce space.

**A** useful caution to Westerners, who too often see China as a homogeneous monolith, is that it is more diverse than we understand and increasingly so. The middle class, which did not exist 35 years ago, is large, growing, traveling and demanding. The “Great Firewall of China”, we are assured, is no match for tech savvy, innovative young professionals who view social media as their new extended family. Graduates from the elite universities are for the first time seeking jobs in the private sector, not government or the SOEs. And even the SOEs are more differentiated in culture and practice than they were, depending on the extent to which they operate in global markets.

Two of the many policy challenges that lie ahead for China particularly stood out at this Ditchley Conference. They were the enormity of China’s environmental problems, particularly expanding droughts, widespread degradation of the water table and unhealthy levels of air pollution in many cities. These rising environmental costs and the slowing of growth should provide the occasion for a massive government infrastructure program geared to cleaning up the skies and water in China’s cities. The other policy problem, which deserves more analysis and discussion, is soaring income inequality and its impact on a society with a sizable middle class and a significant super-wealthy elite for the first time in its history, combined with a shrinking but potentially restive population of rural poor

What about political dynamics, Chinese style? The Communist Party of China has every intention of remaining totally in control, while implementing centrally managed reforms, permitting directed experimentations and encouraging local innovation—a sort of “responsive authoritarianism”. Whatever the West might think, there is no real challenge at present to the Party’s primacy.

On the global stage, China is clearly

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frustrated with the existing international order and its place in it. We should not underestimate the impact on Chinese strategic thinking of the global financial crisis and its perception in Asia of “Western model failure.” The failure of the U.S. to approve reform of the IMF, and to cede a major role in the Asia Development Bank to China, were prominent factors in China’s establishment of the Asian Infrastructure Investment Bank. The “One Belt, One Road” international investment initiative is an attempt to align countries in the region through Chinese-financed economic ties, not unlike Western strategies in the postwar period, and to create a new export market for China’s manufacturers. The energy deal with Russia was both strategic and opportunistic—with Russia reeling from sanctions, it agreed to “European gas pricing” rather than “Asian gas pricing.” Interestingly, as China’s global role rises, its association with the developing countries and the BRICS, appears to be diminishing.

But the most important international relationship is that with the United States and this is now being defined by strategic rivalry in most areas. While some degree of geopolitical and economic competition between these two superpowers is inevitable, the inadequacy of “correcting mechanisms” today—regular summits between leaders; dialogue mechanisms among militaries, officials and business leaders; common perceptions of each other’s objectives—is worrisome. Clearly, China intends to be more of a rule-maker, not just a rule-taker, in the shifting geopolitical order. The central question is: what vision of the world will China espouse, how well will its vision mesh with

that of the West, and will it see its future working predominantly within or outside the existing global order?

China has both bold ambitions and big challenges. Leadership, both in China and in the West will matter greatly to how China evolves. Domestically, China needs to reorient its economic growth model towards domestic demand, build its private sector, reform its SOEs, give the “invisible hand of the market” a freer rein to spur innovation and entrepreneurship, and renew the “social contract” with its citizens—a huge task for any society at any stage of development.

Despite the Western commentary about the dominance of President Xi, some China watchers worried that he may not yet have enough power to effect the enormous structural reforms China requires, while others felt he had the power but questioned whether he had the intent to use it for the needed policy reforms.

**W**hat everyone at Ditchley agreed is that the West lacks strategic coherence in its engagement with a fast-evolving China. One possible approach, advocated by former Australian Prime Minister Kevin Rudd in a recent Harvard report, is that a new “constructive realism” is needed in the relationship, with a common strategic narrative for US-China relations to anchor it, and new regional mechanisms to support it. **P**

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