Will China’s Internal Challenges Limit its Growth as a Superpower?

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Abstract

The rise of China is a topic of much discussion and debate. Acknowledging China as an economic powerhouse, this paper sees two vulnerabilities in China’s economy; its manufacturing export base, and the distribution of wealth within Chinese society. It explores and evaluates how these challenges will impact on China’s ability to become a major global power.

This paper is 12 pages long.
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Introduction

For China, the observation that the ‘rise in a country’s economic status will bring about a corresponding rise in its political status’ has proven accurate. Over the last thirty years, Chinese Communist Party (CCP) economic reforms have led to remarkable economic growth, and the economy has been the foundation for China’s ‘multi-dimensional rise’.

Built on an expanding manufacturing export base, the economy has provided China with the resources to invest locally and in resource-rich countries in Asia, Africa and South America. These investments and closer economic integration into the world economy (particularly in East Asia) and China’s ‘peaceful rise’ diplomacy have enhanced China’s soft power and diplomatic influence. Economic success has provided China with resources to significantly modernise its military programme.

China’s economic reforms have, as Szu-chien Hsu observes, allowed the CCP to coordinate ‘domestic projects, attract FDI [foreign direct investment], absorb or develop technology and know-how, and acquire strategic resources from the world’. Such developments have supported the rise in ‘China’s comprehensive national power’. But, despite its strength, the Chinese economy is vulnerable. This paper argues that CCP economic reforms have also created major challenges for China which, left unaddressed, could limit China’s national power potential.

This paper first examines the CCP economic reforms which laid the foundations for China’s economic development, before discussing two key challenges to China’s rise: the manufacturing export basis of its economy and the unequal distribution of wealth within Chinese society.

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7 Hsu, ‘The domestic origin of China’s rise and its international impact’, p. 65.
China’s Economic Reforms

In 1978 the CCP initiated a process of economic reform, transforming the Chinese economy ‘from a command economy to a market economy’. Deng Xiaoping described the process as ‘crossing a river by stepping from stone to stone’. While preserving the base of the command economy, reforms gradually opened up parts of China’s economy to the market, and some economic control was decentralised to provincial and local governments. Special Economic Zones (SEZ) set up in key coastal provinces allowed tax concessions and provided inducements, attracting FDI. These investments focused on the manufacturing industries. The reforms were very successful, leading to a growth rate of almost 10 per cent every year for the last three decades.

The reforms allowed China to exploit its key national advantage, abundant cheap labour, to establish a manufacturing export base. Labour-intensive industries used China’s low-cost labour to produce goods for the world market, and China’s manufacturing base expanded rapidly. The CCP conducted parallel agricultural reforms, to ‘de-collectivize agriculture’, that freed rural workers for manufacturing tasks. Meanwhile, an increasing Western consumer demand for low-cost goods generated more employment. China’s high level of domestic savings provided investment resources to further develop production capacity. Town and village enterprises, which grew within the decentralised nature of the reforms, benefited particularly from these domestic funds. The reform programme led to a 14-fold increase in the size of the Chinese economy. China became the world’s second largest exporter in 2007 and generated a trade surplus of US$297 billion in 2008. China’s national power has grown with its profound economic success but, to meet its potential, China must continue its strong economic growth.

8 Hsu, ‘The domestic origin of China’s rise and its international impact’, p. 63.
9 Hsu, ‘The domestic origin of China’s rise and its international impact’, p. 56.
18 Morrison, China’s Economic Conditions, p. 5.
19 Morrison, China’s Economic Conditions, p. 3.
20 Morrison, China’s Economic Conditions, p. 8.
An Economy Dependent on Exports and Exposed to External Influences

As the ‘carrier of industrialisation and the main absorber of social employment’, the manufacturing export sector has been the foundation for China’s economic growth. Its vast pool of cheap labour means goods can be produced in China at a fraction of the cost it would take to produce them in the West. For example, production in China has a labour cost of US$1.35 an hour compared to US$24.50 in the United States, SEZ policies and the low cost of production attracted foreign multinational enterprises to invest in China by building their own factories, and to incorporate Chinese companies into their system of global production. Foreign-based multinationals use their own factories in China and Chinese companies to complete the final assembly of goods for export. While this process has maximised the profits of multinational companies and employed millions of Chinese, it has created a reliance on continued strong export demand. So, while China’s manufacturing export base has been the foundation of its growth, it has become a grave vulnerability.

China is reliant on strong external demand, particularly from the European Union, the United States and Hong Kong (51.6 per cent of total exports) to maintain economic momentum. But, as George Friedman observes, China’s manufacturing export base puts it in a ‘position of dependency’. The Chinese economy’s vulnerability to fluctuations in foreign demand for manufactured goods was exposed in the first stages of the Global Financial Crisis (GFC) when the demand for China’s exports fell sharply, following a decline in demand for manufactured goods. Demand from the European Union and the United States dropped considerably, substantially reducing China’s export growth rates.

To-far Wang observes that ‘excessive dependence on exports is synonymous with a loss of control over the domestic economy’. Given the Chinese economy’s reliance

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22 Yue, ‘Peaceful Rise of China: Myth or Reality?’ p. 443
23 2006 figures from EIU Industry Wire, 4 April 2007, quoted in Morrison, China’s Economic Conditions, p. 10.
28 Morrison, China’s Economic Conditions, p. 18.
on external demand, the CCP cannot control the key driver of Chinese economic growth. A reduction in external demand for manufactured goods would lead to an economic contraction within China, resulting in increased unemployment rates. This outcome happened in the GFC, with up to 20 million workers losing their jobs following the initial downturn in demand.\textsuperscript{31} China needs strong demand from overseas markets to purchase its exports to satisfy its immense production capacity. The GFC experience shows that such markets may fail quickly in an economic downturn.

To maintain its level of economic growth, China responded robustly to the GFC with a US$586B\textsuperscript{32} stimulus programme. The programme focused significantly on labour-intensive infrastructure projects. The stimulus package successfully stabilised the level of growth within the Chinese economy, but questions remain about the economy’s sustainability.\textsuperscript{33} The stimulus measures do show the CCP’s level of sensitivity to vulnerabilities in the Chinese economy’s manufacturing base, and the potential for widespread unemployment. There are no quick answers for China if the GFC continues. To insulate its economy from external influences, China would need to significantly increase its own domestic consumption. Such an increase would depend on substantial and long-term social policy improvements in health and education that would encourage lower levels of savings and higher levels of spending in China.\textsuperscript{34} The CCP would need to alter its priorities to boost domestic investment to improve living standards and welfare across Chinese society.\textsuperscript{35}

\textbf{The CCP: Its Economic Policies and Internal Disunity}

The one-party rule of the CCP and its control of economic reforms mean that its legitimacy is tied inextricably to continued economic success.\textsuperscript{36} China’s political and social stability also hinge on continued growth. Three decades of economic growth have benefited many Chinese people—there is a growing middle-class and impressive infrastructure development, and CCP legitimacy has been maintained. But, as Chih-jou Jay Chen observes, ‘China’s progress has been mordantly selective; its uneven economic growth benefits the elite over the workers and farmers, and

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\item \textsuperscript{31} Morrison, \textit{China’s Economic Conditions}, p. 18.
\item \textsuperscript{32} Morrison, \textit{China’s Economic Conditions}, p. 18.
\item \textsuperscript{35} Morrison, \textit{China’s Economic Conditions}, p. 19.
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promotes the development of cities over the countryside’. CCP economic policies have led to an unequal distribution of wealth within Chinese society and regionally. These differences threaten political and social stability.

Poverty remains widespread in China, and the perilous nature of life for workers in China is made worse by key CCP policies. The manufacturing basis of China’s economy puts it in a position where it needs ‘to keep its customers happy’ by keeping the cost of production low. This means a continued downward pressure on the wages of manufacturing workers. The CCP has also sought to maintain China’s cost advantage by keeping the relative value of its currency, the renminbi (RMB), relatively low compared to the US dollar. In 2008, China purchased up to US$1.7 trillion to achieve a comparative value. Unfortunately, China’s export growth generated substantial trade surpluses, which put upward pressure on both the RMB and inflation. Inflationary pressures have the potential to significantly impact on the lowest-paid Chinese workers. Inflation would not just exacerbate the poverty of the majority of the Chinese population; it would accentuate the current wealth disparity within Chinese society.

CCP policies have also generated a coastal/interior wealth divide. Early in its process of economic reform, China established SEZ in key coastal cities in provinces such as Shandong, Fujian and Guandong. Selected for their easy access to export gateways and close proximity to Hong Kong, Macau and Taiwan, SEZ policies included generous tax provisions to encourage foreign investment and the development of factories. The SEZ grew wealthy as they became market economies that encouraged entrepreneurship. With the rest of China subject to CCP central economic planning, and with inefficient and poorly performing industries, a clear disparity developed between the coast and the interior. The SEZ policy, successful in

40 To-far Wang, China’s economic development and its challenges, p. 120.
41 Wang, China’s economic development and its challenges, p. 121.
stimulating economic growth, has been a key factor in accentuating the uneven distribution of wealth. It has also encouraged a major internal population shift.

The disparity in wealth between rural and city dweller is stark, with incomes in cities being over three times the income levels in rural areas. With over 900 million people residing in poor rural areas and 400 million people in cities and the wealthier coast, internal migration and large floating populations of rural workers has emerged as a major societal challenge. It is estimated that 120 million people have migrated from the interior to the coastal provinces to look for work and improve their wealth. Focused development in cities and on the coast has left the vast majority of China outside the benefits of development. The loss of arable land to environmental degradation and industrialisation has exacerbated this situation. Such circumstances set the conditions for social unrest. Through its ‘selective use of Chinese nationalism and political repression’, the CCP has avoided a widespread outbreak of instability. But there is an increasing sense of unrest among those who are missing out on the economy’s success. The unequal distribution of wealth caused by very selective CCP economic reforms now poses a significant threat to political and social stability.

Conclusion

Exceptional economic growth over the last thirty years has been the basis for China’s growth in comprehensive national power. However, to reach its potential China must maintain its strong economic growth and political and social stability. While the CCP’s incremental economic reforms of the last thirty years have transformed the Chinese economy, they have also created challenges that could limit China’s development and its growth as a superpower. China’s manufacturing export-based economy leaves it vulnerable to shifts in external demand, while the unequal distribution of wealth within Chinese society has the potential to threaten political and social stability.

There are signs that the CCP is responding to these challenges. The 2010 National People’s Congress (NPC) approved a budget it hoped would ease housing, education and health costs to free up domestic savings and increase consumer consumption.

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48 Wang, China’s economic development and its challenges, p. 123.
50 Jane’s Sentinel Security Assessment, China and Northeast Asia, 2009, p. 2.
51 Wang, China’s economic development and its challenges, p. 124.
53 Morrison, China’s Economic Conditions, p. 16.
54 Wang, China’s economic development and its challenges, p. 124.
55 STRATFOR, ‘China’s Policies and the Year Ahead’, Intelligence Brief 45/10, 2010, p. 3.
Such an increase would reduce China’s dependence on external demand. The NPC reforms also highlight CCP sensitivities to the risk of social instability\textsuperscript{56} which is rooted in the unequal distribution of wealth. These reforms would address key areas of concern for the lowest-paid Chinese.

However, these reform measures are for the long term, and the CCP would need to maintain China’s strong economic growth during any period of adjustment. Adapting its manufacturing export base and resolving the unequal distribution of wealth within Chinese society are complex challenges for China. The way it deals with and successfully resolves these two underlying challenges are key factors in determining whether or not China succeeds in reaching its economic potential. Only if it reaches this potential is China likely to become a superpower.

\textsuperscript{56} STRATFOR, ‘China’s Policies and the Year Ahead’ \textit{Intelligence Brief} 45/10, 2010, p. 4.
Bibliography


