

8th Waldbroel Group Meeting

on the European and Euro-Atlantic Coordination of Security Policies vis-à-vis the Asia Pacific

Berlin, 14/15 December 2005

*A conference jointly organised by Stiftung Wissenschaft und Politik (SWP), Berlin, and the Federal Ministry of Defence, Berlin*

Discussion Paper

Do Not Cite or Quote without Author's Permission

China's Economic Rise and Asian-Pacific Security  
-Economic Perspectives-

by

Dr. Hanns Guenther Hilpert  
Stiftung Wissenschaft und Politik

**SWP**

Ludwigkirchplatz 3-4

10719 Berlin

Phone +49 30 880 07-0

Fax +49 30 880 07-100

[www.swp-berlin.org](http://www.swp-berlin.org)

The topic of this presentation is China's economic rise and Asian-Pacific security. The theme has two distinct dimensions, first the rather general and crude relationship between China's economic growth and its increasing political weight on the international scene, second the specific implications and actual effects of the emergence of China as a global economic powerhouse for Asia and the world economy as a whole. A last section will conclude.

## 1. China's Economic Growth and International Power Ascendancy

In the two decades after its program of gradual economic reforms has started, China achieved yearly economic growth rates of 9 to 10%, thus quadrupling the size of its GDP from 1980 to 2000. According to official economic planning another quadrupling is scheduled for the following two decades (2000-2020). Although China faces considerable risks, that its economic miracle will stall, the probability that the economy continues its dynamic growth is quite high. If this development holds, China will be Asia's largest economy by 2020 and the world largest by 2050.

Whereas such a pattern of high economic growth spurred by outward oriented development is well known in East Asia from the successes of Japan, Korea and Taiwan, it seems clear, that China's economic growth and integration into the world economy is not a mere repetition of existing pattern. Why not? The China growth story is different for three reasons: First, China's size matters. With its 1.3 billion people and its continental economy the consequences of China's economic rise will be much more felt than it has been in the case of Japan and its Asian followers. Second, unlike its predecessors, China is going through a triple transformation process and thus faces unprecedented transformation risks. Simultaneously China is changing from developing to industrialized country, from a socialist command economy to a free market economy, and from economic periphery to world industrial center. Third, China's economic rise matters politically. Adding to the economic dynamism, China possesses population size, geographical centrality, cultural influence, performs increasing diplomatic activity and carries out military improvements. These are all ingredients for a great international power, (but certainly not yet sufficient for a global power status).

The relationship is evident: China's growing economic weight translates into increasing international political power. Thus the continuation of China's economic dynamism is the necessary (but not sufficient) condition for China's political power ascendancy with all its hotly debated consequences: The balance of power in the Asian-Pacific region may be changing. The non-Chinese outside world feels compelled to react on China's rise. The US is contemplating whether China should be regarded as a strategic partner or as a strategic competitor. Japan, Korea and South-East Asia envision the establishment of an adequate institutional architecture so as to cope with the emergence of the increasing Chinese power.

Whatever the further consequences for international policy and security, the weight that China will carry internationally decisively depends on the further success of its economic transformation and development. However, there is a considerable degree of insecurity when it comes to assess the future economic course of China. There are a great number of potential causes why the Chinese economic miracle might falter: Major disruptions may be caused by civil unrest originating from unemployment, increasing disparities between rich and poor, and expanding corruption. Then there remains enormous risk of widespread financial failures, breakdown in funding for

public investment and resulting damage for growth and investment, as long as the transformation to an efficient free market credit- and capital allocation system has not been accomplished yet. Furthermore, increasing costs for energy, the environment and the much needed build-up of health and social security may prove as major growth impediments. Last not least a military conflict over Taiwan could derail the whole economical development process.

Hitherto China has managed his transformation process quite well by combining skillfully commercial expansion with a governmental policy mix of prudence and flexibility. The majority of China economists seem to be fairly optimistic, that the current dynamic economic development can continue for many more years if not decades. There are many similarities between the China of today and the pioneers of past East Asian growth such as the reliance on competitive markets, the existence of a positive export and investment nexus, capable human resources, rising participation rates, high household savings, the continuous improvement of the physical infrastructure and the strict conservation of macroeconomic stability. If you compare today's China with the past growth pattern of Japan, Korea and Taiwan, you can argue, that China will continue to grow with high single-digit GDP growth rates for many more years if not decades. If China's economy grew with 7.5% p.a. until the year 2040, it would have just repeated Korea's or Taiwan's growth achievements.

Hence the widely held optimism for China seems to be well founded. However, there are also good reasons for some caution. The extrapolation of past trends in the future has never been a reliable prognosis technique. Furthermore economic growth accounting shows that the nature of China's economic growth is very different from the former pattern of East Asian economic growth. First, systemic transformation is a main component of China's economic growth story, because the continuing improvements of allocation efficiency are driving China's total factor productivity growth. Second, China's economic growth is – compared with Japan, Korea and Taiwan - less export-led and more domestic demand-led. Therefore the continuation of the hitherto successful transformation process is the very crucial condition for the maintenance of China's economic growth. In future the migration of China's labor to more productive uses and the ongoing transformation to a free market economy remains the crucial driving force for economic growth.

To conclude, the further continuation of China's economic growth is not a certainty. But the probability is high, that the process can be maintained for a considerable time.

## 2. The Impact of China's Economic Rise: Risks and Opportunities

### 2.1. A Comprehensive Understanding of Security

Geopolitical changes and tensions are not the only security risks originating from the economic rise of China. The actual risks real politics dealing with China are much more varied and more extensive. Since China's domestic transformation has been more economical than political, China's impact on the world is also more economical than political. China's global economic emergence has major effects on Asia as well as on industrialized countries and on the developing world as a whole. They all are more and more exposed to the opportunities and risks of China's domestic development process. To mention only some of the most obvious impact incidences: (1) China has risen as a prominent consumer for scarce energy and

natural resources, (2) China cost-cutting competition in wage-intensive manufactured production is threatening well-established production locations in both the developing and developed world, (3) China's has emerged as the second major holder of foreign exchange reserves and US Treasury Bonds. (4) The ecological impact of China's industrialization is increasingly felt in the neighboring Asian countries.

These four incidences are exemplary indications of how the world is affected by China's emergence as a global economy. They show that there are substantial non-military risks for the Asian Pacific region, although these risks are in essence not military ones. Therefore the further discussion will be based on such a comprehensive understanding of security, which includes the economical, social and ecological aspects of security adding to the military and political issues.

## 2.2. Negative Scenario: Transformation Failure

For an assessment of the international economic impact of China's economic rise, again an assumption on the future course of the Chinese economy has to be made. As has been elaborated before, there are more reasons to be optimistic than to be pessimistic for the Chinese development and growth. That's why the following discussion will generally assume the continuation of high economic growth for some more years. However, the widely held China optimism notwithstanding, transformation failure and a thereby resulting breakdown of the previously successful growth and investment cycle is really possible. If such unfortunate events occurred, the economic and social repercussions for neighboring Asia as well as for the rest of the world would be severe. If China's internal stability cannot be maintained, a detrimental impact on the rest of Asia must be expected. Social upheaval, failing reforms and an end of economic transformation could spill over China's borders and spread unrest and instability in the whole of Asia.

But even assuming a less frightening case in which the reform momentum could be basically maintained and the Chinese economy would "only" heading for a hard landing, no other region would suffer as much as neighbouring Asia. The IMF estimates that China contributed to about 24 % of world economic growth during the last three years. No other region has profited as much from the Chinese engine of growth as Asia and Japan. But a reverse logic exists as well: The loss of the Chinese growth locomotive could certainly derail the less robust Asian Pacific economies.

These potentially negative consequences make clear that Asia and the world has a high stake in successful transformation of the Chinese economy. It makes sense to support this process through China's further integration into the regional partition of labour and by integration into its regional structures. And there is a second preliminary conclusion for China's economic partners. Since such unpleasant scenarios cannot be excluded, there is a strategic necessity for economic and financial contingency planning.

### 2.3. Positive Scenario: Continuation of High Economic Growth

What are the implications of China's economic rise in the case of the more likely rosy scenario of successful continuation of high domestic growth and rapid integration into international markets? In what way is the world affected by the re-entering of China in the world economy? China's impact already has many features and their relevance will probably increase with time. The following structured list of major developmental trends – though not complete - includes the most important aspects. It depends on circumstances which of the issues is the most significant in international politics and international economics.

Rising Chinese shares in regional output, trade and capital flows: At PPP rates China is already the biggest Asian economy, at market rates it will be the biggest within 10 to 15 years, provided current trends continue. Already since the early 1990s China is the largest recipient of FDI in the region, at times attracting even more FDI capital than the US. In 2004 China surpassed Japan as Asia's biggest importer and exporter. China will also replace Japan as the country with the largest foreign exchange reserves in the world. In pure economic calculus these rising Chinese weights in regional output, trade and capital per se represent above all increasing opportunities for China's economic partners. Since trade and economics are not a zero-sum game, China's economic rise is not necessarily at the expense of its neighbours. But it comes as a relative shift of weight and political power. It is natural that China will play a prominent role in regional institutions and organisations.

Changing regional trade flows: The geographical distribution of China's trade growth is not even. Whereas China's exports to industrial economies have grown faster than those to Asia, China's imports from Asia have grown notably faster than those from industrialized economies. As a result, for developing Asia exports to China are getting more and more important, although North America, Japan and Europe remain their most important markets for the time being. Developing Asia, which is losing market share in industrialized countries to China, is compensated by increasing exports to China. With vertical production networks deepening in Asia, it gets increasingly important to supply a range of production complementary to China's economy. Therefore it can be expected that industrial specialisation intensifies in Asia and the regional economic integration increases. As a result of this development regional center-periphery relations come into being with the Bohai Rim and South China as the evolving industrial centers of East Asia. Mutual dependency within Asia increases further.

Price effects and changing Terms of Trade: China's abundant labour force with its respectable education and work ethic combined with continuing high levels of capital investment and a modern industrial infrastructure have turned China to the industrial workshop of the world. Based on his comparative advantage China continues to expand the global production and the supply of low-skilled labour intensive goods to the world economy. China's upcoming presence in the international partition of labour has led to a fundamental shift in relative prices. China's impact on relative prices comes from the demand and the supply side: On the one hand, China's rising supply of labour intensive manufactured goods is lowering the world market prices of these goods. On the other hand, China's growing demand for energy, commodities and immediate inputs for processing is increasing the prices of these products. In addition, China's growing demand for capital- and skill-intensive goods is raising prices for these goods.

Chinese demand for energy, raw material and many other natural resources has grown more rapidly than their global availability has increased. The result has been a significant price hike in non-renewable products like petroleum, nickel, copper and zinc. In the longer term the higher costs will both stimulate new exploration and the search for substitutes and it will intensify conservation efforts. But this self-correcting mechanism takes time and at present China has aggressively ventured worldwide to open up new sources for their energy and raw material needs. As a result various rival resource bidding has occurred and in various occasions China conflicted with international non-proliferation or human rights policy (Iran, Sudan). Here it is important to differentiate. On the one hand it is essential that China will be able to gain access to energy and resource markets on the basis of market price, although we live in a world in which diplomatic and military linkages also influence long-term energy contracts. On the other hand China must be reminded that the participation in the international economy requires a certain extent of responsibility for international security, peace and stability.

The relative price shifts have also significant distribution effects: Economies or firms complementary to China, which are supplying goods China needs and which are importing goods China produces, enjoy improving terms of trade. Economies or firms, competitive to China, however, suffer aggravating terms of trade. For example consumers worldwide profit from the lower prices and better availability of goods, which can be manufactured at low costs in China. On the other hand producers of these goods in industrial and developing countries suffer from their loss of competitiveness. As a result many non-Chinese manufacturing locations have to be closed, unless societies accept a dramatic deterioration in income distribution. Therefore both industrial countries and developing countries must respond to these opportunities and challenges China represents. Industrial countries have to restructure their labour force and partly upgrade them, they have to carry out corporate deregulation, and they have to expand in sectors complementary to China such as capital-intensive and skill-intensive goods or services. The probably more difficult adjustment part, however, comes for the developing countries. With China competing successfully in labour intensive segments, for low income countries the well established Asian development path of specializing in labour intensive manufacturing and carrying out an export led growth strategy becomes less feasible. Developing economies must fear to fall back to the status of a resource supplier country. With China targeting also the technology intensive segments, for the newly industrialising economies of Asia the continuation of their growth process is getting increasingly difficult. They must fear to fall back in their catching-up and growth process.

A currency anchor for Asia: For the increasingly integrated East Asian economies, China's somewhat loosened yuan/dollar peg has become the key to intra East Asian exchange rate stability. All Asian economies more or less peg to the US-Dollar and thus to each other. This fixed rate system provides East Asia low transaction costs in its intraregional trade, it reduces exchange rate risks (in the underdeveloped financial markets) and it imports macroeconomic stability. The yuan has taken over a role which has been previously assumed by the Japanese yen.

Migration: Chinese migration from rural to urban areas is above all a domestic issue. The international spill-over effects are still comparatively small. Nevertheless the emigration of Chinese students (and their subsequent working overseas) and the immigration of (both Chinese and foreign) management and technology specialists

has proven economically beneficial for all parts involved, There are also Chinese migrants who successfully occupy lucrative business fields in China's poorer neighbouring countries, such as Indochina, Mongolia and North Korea. Economic rents are earned more and more by Chinese and less and less by locals. The latter trend generates grievances and tensions at the grass root level.

Environmental Impact: Poor countries with pressing demands to feed, clothe and house their people, usually neglect the (external) environmental costs of industrial production as long as such behaviour is tolerated by the communities concerned. Apparently China has arrived at this stage, possibly she has passed it already. The problems of water, air, noise pollution, of soil erosion, grassland degradation and desertification have grown to such an extent that China's environment has become a regional issue. The Korean peninsula and large parts of Japan are suffering from acid rain and yellow sand storms. Indochina is complaining of Mekong resource depletion. And the world is concerned about Chinese CO<sub>2</sub> emissions. Thus China's environmental has a political and an industrial dimension. Politically bilateral consultations and/or international institutions are needed to make China render account for its unwanted export of environmental damage. However, the responsibility for leadership in reducing global CO<sub>2</sub> emissions lies with the countries with the highest per capita emissions. Industrially the products and technology available to curb pollution and to contain degradation can be best supplied from industrialized countries.

### 3. Conclusions

Although the further continuation of China's economic growth is not a certainty, the probability is high, that the process can be maintained for a considerable time.

With China's powerful emergence as a global economic force huge shifts in the international pattern of production and consumption have occurred. As a result even the domestic economies of China's trading partners in Asia and the world are affected. Generally China offers risks and opportunities. As a response each trading partner can react effectively or defensively. If the reaction is defensively, the result will be slower growth, longer adjustment periods and a fall behind the countries that successfully adjust to China's emergence.

An effective reaction must have a national and an international dimension. Nationally the adjustment and/or upgrading of production structures and, the restructuring of labour forces are the most urgent tasks. Internationally China should be constantly reminded of her responsibility for the international system, notably in the fields of non-proliferation security, environment, rule of law and human rights. The chances of success may be greater, if China is well integrated into regional or global institutional structures.