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ESSAY

# CHINA AT THE CROSSROADS

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SUMMARY

China has reached a crossroads. Its method of collective leadership has ensured overall stability but it has also resulted in a “success trap”. During the last two years, China’s economic performance has fed international assertiveness and authoritarian trends at home. But as the regime seeks to change its growth model, it requires more control of, and independence from, vested interests. The recent fall of Bo Xilai and the political movement in Guangdong province have seemed to produce a sudden political shift at the top. At the People’s Congress in March, Premier Wen Jiabao made a clear argument for the rule of law and warned of the possible return of tragedies such as the Cultural Revolution.

China can now either regress into nationalism and mass movement politics, or take a path of political and legal reforms that would restrict the concentration of power and collusion of interests at the top. The introduction of new checks and balances and promotion of sustainable growth would quickly reduce macroeconomic imbalances and overreliance on the dollar. China would have an incentive to diversify its existing currency reserves. Reformers will also favour regional integration, the multilateral system and rules over blind geo-economic and geopolitical competition. On the other hand, a standstill would actually lead to even more authoritarianism at home and conflict abroad.

This year, two political events have rocked China. In the village of Wukan, in Guangdong province, villagers seeking to reclaim their voting rights and oust their corrupt local leaders were vindicated in full view of the international media after several months of protest. Meanwhile, in Chongqing, Bo Xilai, the Politburo member whose play on Maoist rhetoric and targeted use of violence frightened many in China, was ousted in March after his police chief Wang Lijun sought refuge in the US consulate in Chengdu. These two events have turned Chinese politics on its head. The outcome of the Wukan revolt encouraged political reformers both inside and outside the leadership to speak their minds. Suddenly pro-reform and liberal arguments that had seemed to be marginalised during the past two years are reappearing in the official media and Premier Wen Jiabao repeated many of them in his speeches to the national legislature in March. Meanwhile, for the first time, China’s censorship machine is silencing nationalist, populist and conservative websites and spokesmen.

At the same time, key issues on China’s international economic agenda – most notably, the lifting of capital controls and the speeding up of liberalising reforms – are again being debated, and often explicitly linked to a break with the political past. There is criticism of China’s gradualist approach to reform – epitomised by the adage “crossing the river by feeling the stones” – for strengthening vested interests. Some are now calling for top-down reform – “crossing the river to the other side” – in order to escape what is described as a “transition trap”.

It is too early to say if the call for self-government in Wukan, which was strongly evocative of the first peasant soviets set up there in the 1920s, and the Chongqing drama, which appears to have been lifted from a martial arts novel, are the product of fate, or whether there has been a concerted offensive from some quarters to at least seize on these opportunities. The almost complete lack of censorship on Chinese websites about the Chongqing drama suggests that there has been a shift at the top of the Communist party. As one door to reform and change seems to have opened, another for regression to the mass campaign politics of the Mao era appears to have closed.

These events are relevant to China's international partners. International investors have often cosied up to an authoritarian system that delivers cheap labour and stability for investors. But China's state-led economy, its bias towards investment over consumption and social welfare have contributed to global imbalances and the crisis. Reformers would seek to rebalance the economy and end the extraordinary financial waste that results from a more than 50 percent rate of savings and accumulation of another country's currency. They would also empower China's citizenry and reduce the gap with international governance and norms. And, in an open economy and society, many of China's brilliant entrepreneurs would become formidable international actors.

Conversely, attempts at reform could backfire and lead to a hardened conservative resolve. The one-party system has built up legal processes, but has stopped in its tracks most political change in the past decade. What China's international partners and the Chinese themselves have to fear most is fear itself – the fear of change by political leaders who would rather postpone any risky endeavours into the future and live as long as they can with the contradictions of China's new bureaucratic capitalism.

## China's success trap

China has had phenomenal successes in the past 33 years since "reform and opening up" took hold inside a party that was reeling from Maoist and Cultural Revolution misdeeds. These successes suggested that the country and its one-party leadership had found a stable growth path. What began as an experiment became a transition and in recent years has often been hyped as a new model – the so-called Beijing Consensus. The China model could indeed represent an attractive alternative for countries repulsed by the vagaries of the democratic process, by the crises caused by liberal economic theories, and by the loss of sovereignty implied in expanding international norms. Open, yet in control: the Chinese experience has belied the old Tocquevillian adage that governments are never more in danger than when they start to reform.

For most of this reform era, China's leaders never talked about a "model". They presented their policies as a way to

catch up with development, modernise and experiment with various models brought from outside. Reversibility, stability and non-intervention were the other terms of this opening-up strategy. Since 1989 and the crushing of political liberalism inside the party and the urban elite, few choices have been left open. The Tiananmen turning point resulted in a move towards "core leadership", against any factional play or political wings. This, together with an increased accent on protecting state secrets, severely limits debate outside the party. Those limitations are as much a guarantee against a return to Maoism as a cap on liberal and democratic advocacy: stage-managing public debate had been an earlier feature of power struggle, because Mao championed "riding the tiger". He created and utilised "mass movements" to advance his views – and topple his opponents.

Two trends have become evident in Chinese politics in the last decade – a decade that coincides with Hu Jintao's two terms at the head of the party-state. The first is that a formal consensus or union around the "core" has become even more constraining. The second is that what began as a piecemeal method of experimenting and generalising reforms, often described as "crossing the river by feeling the stones", has hardened into a ritualised model both for China and for others.

The first trend is exemplified by Hu's insistence on "harmony". The theme has Confucian undertones, but it has also been ridiculed by Chinese web activists as it has become synonymous with preventing debate. Hu's tenure has also coincided with a shrinking of democratic experiments into an intra-party process that took place behind closed doors. The state itself has seen many useful procedural reforms, but no progress towards constitutional rule. For example, from August 2011 to March 2012, a draft new criminal procedure code was open to public discussion – a positive step for a major law. But at the heart of the new code lies a provision legalising secret detention for up to six months in cases ranging from terrorism and subversion of the state to major corruption acts. To this day, the official viewpoint is that these detentions aren't secret since authorities carry them out, and this glaring contradiction illustrates why a state of laws and processes cannot be equated with the rule of law.

However, despite these illiberal steps, Hu's tenure has not been quite the regressive era that some critics describe. Societal freedom, including the freedom to migrate internally and to travel internationally, has vastly increased. Lawyers, legal aid societies and NGOs have vastly increased in numbers and range of activities. What is essentially a one-party system has tried to install "checks without balances" – controlling, supervising and renovating itself in what looks like another Utopia of policies without politics. Inevitably, the Singapore model comes to mind, but Singapore has only six million people and a per capita income of \$50,000. Although one family has dominated its politics since 1955, limited but nonetheless real elections act as a safety valve and a reality check.

The second trend is unquestionably a result of the intoxicating effect of success and the hold on power by vested interests, which has created the temptation to hype a “China model”. Unprecedented international economic imbalances – in 2008, China’s current account surplus reached 10 percent of its GDP – have created the notion of an economy that cannot fail or even falter. Indeed, many economic players with vested interests, from state-owned enterprises to real estate developers and local authorities selling land for gold, have assumed the run would never end. But this was actually the result of exceptional conditions: unfettered access to world markets as a developing economy without being obliged to open much of its own economy to competition; a policy of “financial repression” preventing the revaluation of the yuan; and an epochal increase in the size of its labour force.<sup>1</sup>

These two trends have merged in the last decade. Economic success made possible an impulse at the top to “end history” with a self-balanced party system that regenerates itself to perpetuate control. China’s party-state system creates a bias towards continuity. But economic success was achieved in a catch-up phase under exceptional conditions granted inside the international system. China’s reformers talk about the dangers of a “Great Leap mentality” – a reference to the way that the collective fever spread by Mao in 1958 resulted in a national tragedy soon afterwards. What is dangerous this time around is the expectation that the run will never end. China’s economic success has led to political stagnation – what can be described as China’s “success trap”.

After all, China’s leadership has not been wrong about everything: within a third of a century, it has raised the country’s per capita income from \$278 to \$6,200, achieved a drop in poverty rates from two thirds to 13 percent of the population, and turned into the world’s second largest economy and its leading exporter.<sup>2</sup> China is the only country in the world in which local authorities, trapped in their income-generating investment plans, deliver more growth than is asked from them.

## The nationalist and conservative challenge

This phenomenal success, which not even the global crisis of 2008 could derail, is increasingly under attack. The last two years have seen a rise in challenges to what was previously taken to be the prevailing consensus – or “mainstream thought” (*zhuliu sixiang*), as official commentators like to call it. But contrary to what many in the West think, these challenges come not so much from liberals or reformers but from hardliners. Whether they should be labelled conservative, nationalist, populist or leftist depends on

one’s point of view. In particular, three types of views have been expressed in the past two years.

Some have expressed a belief that, as China rises and thus erases the limitations and humiliations of its past, it should also be more assertive in its foreign policy. Where reformers advocate more international co-operation and a commitment to international values, these nationalist critics want to recover lost territories and position China as a geopolitical great power. Others have decried China’s management of its huge financial surpluses, and the losses sustained on dollar reserves. They argue that it is the reforms that have brought increased inequity, and advocate a return to statist policies. There are also broader ideological attacks on reform and political liberalism. These attacks also include the glorification by part of the established elite as well as by the propaganda and security apparatus of the authoritarian and hard-power features of China’s heritage.

But who knows whether the leadership approves these views? In February, a leading hard-line party newspaper, *Global Times*, explained that while one must “believe the Party Centre” (*xiangxin dangzhongqiang*), the leadership needs to clarify what its line is.<sup>3</sup> In the run-up to the November 2012 Party Congress, at which seven of the nine members of the Politburo Standing Committee – China’s top policymaking body – are expected to be replaced, succession issues have become central. During past high level “line debates” or power struggles in the post-Mao era, rumours, which often spread via Hong Kong publications, tended to bolster reformist or liberal views and their promoters. But in the past two years the rumours have often come instead from the political and think-tank milieu in Beijing and have tended to discredit either the reformers or the country’s top leader. Wen has been widely described as powerless or dissembling, and his close family as having questionable business dealings. Li Keqiang, Wen’s potential successor and generally regarded as a reformer, has been described as having inadequate skills to manage the economy.

Hu himself has been described as indecisive and out of touch on key foreign and security policy issues – particularly after disputes with Vietnam and the Philippines in 2010. The issue of Hu’s control surfaced again when harsh nationalist views from semi-retired People’s Liberation Army (PLA) officers came to the fore in the autumn of 2010. The view was reinforced in January 2011, when Hu seemed unaware of the public testing of China’s new stealth fighter on the same day he met with US Defence Secretary Robert Gates. In fact, Hu would have known that two of his colleagues in the Politburo Standing Committee watched the test flight in Chengdu. Thus, rather than being indecisive, he appears to have authorised a balancing game in which conservative and nationalist forces inside the party-state offset liberalising trends in China’s society.

<sup>1</sup> Financial repression implies buying up dollars from China’s exporters and banks, therefore releasing more yuan into the domestic economy. If the financial repression stops, so does the increase of the domestic monetary mass and credit available.

<sup>2</sup> Per capita income figures for 1978 and 2012, defined in real monetary terms, are from the World Bank. The poverty level in 1980 and 2008 is defined as \$1.25 per day in purchasing power parity (PPP) terms, and these estimates are also from the World Bank.

<sup>3</sup> “Chongqing jiaozhenghou de Zhongguo shihui lixing” (After the readjustment in Chongqing, China’s societal rationality), *Huanqiu Shibao* (Global Times), 22 March 2012, available at <http://opinion.huanqiu.com/roll/2012-03/2545323.html>.

This balancing game, however, could only endure if the players on both sides were ready to concede when asked, in the interest of harmony. And indeed, retired generals airing bellicose views were ready to admit they spoke only for themselves. Public intellectuals courting the media with hard-line talk and cultural chauvinism ask for more, not less, party and state authority. They conveniently offset the fascination of China's civil society with all things foreign.

There are indications that many of China's "princelings" (the children of past leaders) have formed a quasi-union. The origin of this can be traced to a 1992 decision inspired by Bo Yibo, a former close associate of Mao, that each leading "family" would be able to promote one child into top politics.<sup>4</sup> The list of the children or in-laws of past leaders who are in key positions or are moving up the ladder is so large it could fill a telephone directory.<sup>5</sup> That certainly could not suit Hu, who has based much of his career on regenerating the party from its recruiting arm among the young, the Communist Youth League. But this is slow asphyxiation, unlikely to reach its conclusion on Hu's watch. And "princelings" are also divided by their fathers' history and past power struggles.

One of these "princelings", Bo Yibo's son Bo Xilai, mounted a challenge to the collective leadership by combining his family influence with Maoist ideology and nostalgia. Bo aspired to join the Politburo Standing Committee in 2007 but was sent to Chongqing instead. In that inland metropolis of 32 million people, he quickly launched a major anti-mafia campaign that was soon called "strike black" (*dahei*), in reference to black societies or triads. He coupled it with the promotion of "red songs" (*changhong*) from Mao's revolutionary repertoire. He also ran an exceptionally high-profile campaign to promote a "Chongqing model". Two of these three actions were hardly new: there have been "strike hard" campaigns since 1983, including one in Guangdong province at the same time, and the main economic and social features of the "Chongqing model" were in fact set before Bo Xilai was appointed there.

However, although maybe not completely original, Bo was exceptionally slick, or perhaps manipulative, in orchestrating his fame across the nation and via visiting luminaries. His "strike black" campaign targeted (and eventually liquidated) key subordinates of previous local leaders such as He Guoqiang, the powerful leader of the party's Inspection and Discipline Commission, and Wang Yang, the reformist leader of Guangdong who has been visibly close to Wen. Worse, word got out from Bo Xilai's camp that the campaign might serve to flush out important power backers of mafia groups elsewhere in China. The "red song" element – Bo's only true innovation – also constituted a form of ideological blackmail on legalist or reformer elements of the leadership.

Until 2010, central leaders had not given the Chongqing model or Bo's "strike hard" campaign their stamp of approval. But China's security chief Zhou Yongkang (who had initiated a crackdown on Google in China in the spring of 2010, reportedly after seeing items regarding his own family relatives) visited Chongqing in November 2010. Coincidentally, in September 2010, the captain of a Chinese fishing boat had deliberately rammed a Japanese coastguard ship in disputed waters around the Diaoyutai/Senkaku islands and was detained as a result. This led in October to a popular anti-Japanese movement in which well-organised demonstrations in Chongqing and Chengdu (which were bombed by Japan in World War II but never occupied) figured prominently. In December 2010, expected successor Xi Jinping also visited Chongqing. By contrast, President Hu and Premier Wen have kept their distance from Chongqing since the end of 2008. Six days before his downfall in March 2012, Bo called publicly on Hu to visit his city.

## From assertiveness to political regression

For most of 2010, the tensions in China's public politics had focused on its relations with its neighbours and with the US. But, from November onwards, they shifted to the domestic scene. Human rights activists and lawyers were secretly detained. Many of them have been threatened with being "buried alive", a veiled allusion to Qin Shi Huangdi (the first Qin emperor buried legal scholars alive – and was a favourite reference of Mao during the Cultural Revolution). Ai Weiwei, the political and cultural activist who helped create the "bird's nest" design for the Beijing Olympic Stadium, faced the same threat when he was detained in February 2011. Ai's guards also told him that nothing had changed since the Cultural Revolution and that China's former president Liu Shaoqi had died in jail "holding the constitution in his hands". In August 2011, on the eve of a trip to Europe by Wen, Ai was released and put under house arrest. But, at the same time, the new draft criminal procedure code was published, with a provision to legalise secret detention under the euphemism of "residential arrest", which actually means any locale that the police see fit to use.

Thus, within two years, China's political climate had darkened. What had started as self-assertion of Chinese success in the face of Western crisis and perceived "decline", had now taken the form of epidemic challenges over borders, maritime use and continued US surveillance close to China. And, finally, it was producing domestic security campaigns challenging the trend towards legal rule, and making thinly veiled threats aimed at the more legal-minded leaders inside the party.

The true leanings of China's number one in the collective leadership during this shift have remained very hard to assess. In contrast to Deng Xiaoping, who used factional dynamics to advance his reforms or, on the contrary, to contain calls for political reform – the "guerrilla style" in Chinese politics – his successors have turned towards procedural

<sup>4</sup> Cheng Li, *China's Leaders: The New Generation*, (Lanham, MD: Rowman & Littlefield Publishers, 2001), p. 131.

<sup>5</sup> For a very preliminary shortlist, see China Vitae, "Prominent Chinese Families", available at <http://www.chinavitae.com/library/prominent-families>.

rules and routinisation as their main political strategy. Hu appears to encourage a synthesis to which he holds the key. But “harmony” has become a catchword for suppression of debate – so much so that when websites are closed down, tweets deleted or critics called in by the police for a friendly warning, they are said to have been “harmonised”.

This focus on “harmony” may also have willingly or unwittingly encouraged conservative and authoritarian pressure. There is reason to believe that in February 2011, with the advent of the “Jasmine revolution” and Arab Awakening, Hu at least followed, if not led, the Politburo into an all-out decision prioritising the “preservation of stability” (*weiwen*): in 2012, China’s national and local budgets now exceed its \$114 billion defence expenditure. Hu first condoned an assertive foreign policy, but checked it in time for a visit to the United States in December 2010. He now played along with a domestic onslaught of security policies, aimed at dissidents, open critics and also at the fast-expanding social networks that have sprung up in China.

These three trends – assertiveness and incidents with the Asian neighbourhood and the US, a challenge to any domestic legal or liberal transition, and a retreat to a more closed state-led economy – have profound implications for China’s international partners. If confirmed over time, they would put China on a path of international conflict. And given China’s share of global exchanges and resources, they would also challenge the feasibility of global governance.

Faced with these nationalist, militaristic, populist and conservative trends, the liberal camp seemed exhausted. In addition, the economic context was not favourable to extensive new reforms. China’s strengthened international position and the global failure of economic and financial liberalism have encouraged a move back to a command economy. Schemes for “indigenous innovation”, the designation of new sectors that are off-limits to international investors, an increasing use of behind-the-border trade barriers by a China that is also set on creating its own norms, and quite simply the extraordinary availability of cheap capital and credits have prevailed over calls for market competition.

In this context, much of the central technocrats’ energy had been spent on finding the brakes and cooling off public and shadow finance banking, capital investment by local authorities and state-owned enterprises, and land and real estate speculation. Wen’s government began an enforced slowdown of lending and investment in 2008 (i.e. before the global crisis actually struck), launched a massive counter-cyclical stimulus package in early 2009, raised bank reserve ratios and interest rates in 2011 in order to cool inflation, and expanded social housing and old-age retirement systems that will ultimately create social stabilisers for much of the population.

However, these policies presumably drained all remaining energy in the reformist camp, so that moves towards currency convertibility and a lifting of capital controls did not happen in 2010–11. Instead, financial repression

deepened: currency reserves reached a historic peak of \$3.25 trillion in September 2011, and the much-vaunted internationalisation of the Chinese yuan took the form of mercantilist agreements for payments with trade partners and a well-separated offshore market in Hong Kong.

## Wen Jiabao’s liberal counter-offensive

In China, however, politics neither starts nor ends with economics. International observers were probably wrong to dismiss the repeated moves that Wen has taken for political liberalisation, or as a counter-offensive against conservative forces. For example, in early 2010, he paid a rare if personal rather than political tribute to the late Hu Yaobang, who became an advocate of political liberalisation in 1986. Deng Xiaoping had removed Hu at an enlarged Politburo meeting in January 1987, where he was accused by Bo Xilai’s father, Bo Yibo. In 2010, Wen celebrated the anniversary of the May Fourth Movement – the cultural and political movement that began with student protests in 1919 – at Beijing University. In August 2010, in Shenzhen, the site of the first experiments with liberalisation and a city that has also been more open than any other region of China, he called for political liberalisation, emancipation of minds and preventing “excessive unchecked concentration of power”.

Interviewed by CNN in September 2010, Wen retreated under Deng Xiaoping’s political legacy, but emotionally declared that “absolutely no one may disobey the law”. His utterances were not widely reported by the official central media and a *People’s Daily* editorial railed against claims that “political restructuring has lagged behind”.<sup>6</sup> Soon, as the Chongqing model was being touted to Chinese and foreigners alike, an alternative “model” appeared in Guangdong, which is run by Party Secretary Wang Yang. It advocated a move towards high-tech and higher paying jobs, an expansion of civil society and NGOs, and a fleshing out of legal rule, although it was decidedly short on social policies.<sup>7</sup> Wen had earlier spoken from Guangdong and extolled Deng Xiaoping’s January 1992 “southern tour” which restarted economic reforms. The Guangzhou and Shenzhen media have come out more often for reforms than the national media.

Discreet signs of political conflict at the top continued into 2011. In January, the authorities erected a statue of Confucius in Tiananmen Square, then replaced it in April with one of Sun Yat-sen. (Confucius, who has been alternatively glorified or pilloried since the beginning of the twentieth century, represents a conservative rallying cry against liberalisation; Sun Yat-sen, the founder of the first Chinese republic in 1911, unquestionably symbolises institutional democracy,

<sup>6</sup> The article was signed with a group pseudonym, Zheng Qingyuan, which is similar to a proverb that means “rectifying from scratch”. The article is available at <http://english.peopledaily.com.cn/90001/90780/91342/7179354.html>

<sup>7</sup> See “China Analysis: One or two Chinese models?”, European Council on Foreign Relations / Asia Centre, December 2011, available at [http://www.ecfr.eu/page/-/China\\_Analysis\\_One\\_or\\_two\\_Chinese\\_models\\_November2011.pdf](http://www.ecfr.eu/page/-/China_Analysis_One_or_two_Chinese_models_November2011.pdf).

albeit with Chinese characteristics.) Around the same time, more allegations about the leadership began to surface. One, attributed to PLA circles, was that Xi Jinping and Bo Xilai were unfit to lead China because of their personal ties with the US (for example, both have children enrolled at Harvard). During the People's National Congress meeting of March 2012, Wen and Bo both complained publicly of rumours concerning their family. Such public factional infighting has not happened since 1989.

This infighting also seemed to extend to Chinese foreign policy. In May 2010, Wen visited South Korea and met with President Lee Myung-bak in the wake of the North Korean sinking of a South Korean military vessel. When asked by Lee why China co-operated with North Korea by handing over North Korean refugees, Wen remained silent for several minutes – an indirect acknowledgment that he did not support the policy. In July, China stood by North Korea at the United Nations, preventing its condemnation for the incident. The negative consequences of this decision appeared when North Korean artillery shelled an inhabited island in the Yellow Sea in December 2010. By that time, China's leadership was ready to restrain the hawks, and internationally co-operative viewpoints began appearing again in think-tank journals and the media after a new chord was struck at the top.

This turn for the better was confirmed in 2011. In late February, China voted for UN Security Council Resolution 1970 on Libya, which invoked the responsibility to protect civilians and referred potential war criminals in Libya to the International Criminal Court. This decision, made over a weekend, may have come back to haunt its backers in Beijing: when the West gave full military support to the rebel camp against Muammar Gaddafi, state firms and strategy hawks railed against the government, which they believed had sacrificed Chinese interests by giving a green light at the UN. In July 2011, after months of renewed incidents on fishing rights in the South China Sea and China's very extensive claims of an Exclusive Economic Zone (EEZ), China made a renewed commitment to negotiate with Southeast Asian countries over maritime claims. Against the lobbying from China's navy and the State Oceanic Administration, China's foreign ministry has clarified that its claims regarding China's EEZ do not mean China regards the entire South China Sea as Chinese territory.

## The economic case for reform

Finally, from the summer of 2011 onwards, Chinese economic policy also started to change, although we only know about it in retrospect. From July to December 2011, monthly statistics of the main foreign buyers of US public debt show that China has, for the first time since 1998, started to sell some of its US Treasury holdings, bringing down the total amount by 13 percent from its record high of \$1.315 trillion in July 2011. At the World Economic Forum in Dalian, in September, Wen also made a positive declaration

about the purchase of European public debt. By contrast, Chen Deming, the minister of commerce, only spoke of the investment opportunities that Europe's crisis offered to Chinese firms. Over the next few months, the fallout from the euro crisis led to a slowdown in exports and an increase in imports, also pushed by heavy investments inside China and by high prices for energy. By February 2012, China's trade surplus had turned into a \$31 billion monthly deficit. China's overall currency reserves also started declining in the last quarter of 2011.

This change in Chinese policy is in part a result of developments in the global economy. The European slowdown and the euro's 20 percent depreciation against the yuan are impacting Chinese exports, while China's trade surplus with the US reached a record \$300 billion in 2011. The depreciation of the euro and the unsustainability of the trade gap with the US have capped expectations of a higher yuan. For the first time in years, hot money is flowing out rather than in. The new Hong Kong offshore yuan market has suddenly lost its appeal, as investors no longer see it as an avenue into mainland lending opportunities.

But there has also been a policy change. Instead of launching another stimulus spending package, as it did in 2009, China has stepped on the brakes in order to cool inflation and slow down investment. Had it followed the 2009 precedent, China would have avoided an economic slowdown. But it would have also built an even higher pyramid of questionable loans and investments inside China. China's railway ministry alone is estimated to have racked up \$341 billion of debt over the planned construction of its 20,000 km bullet train network: the fall of its minister on corruption charges in February 2011 had already indicated that tensions were running high on this front. In response to this case, officials had begun warning against a "Great Leap mentality".

Instead of launching another stimulus plan, the Wen government has embarked on a path that leads inevitably to a renewed focus on major economic and financial reform. By restraining new credit and investment, and by shorting the dollar, China commits itself to innovative policies in two major areas. Firstly, it must again encourage market reforms and find ways to tax more fairly the huge accumulated wealth of the past decade, in order to fund the rebalancing of the economy towards social spending and domestic consumption. Secondly, it must create a foreign investment and lending strategy that will complement and in some cases replace the overreliance on dollar reserves.

In the first area, this means legal, administrative and political reform. The agents of growth can no longer be a small number of quasi-monopoly actors, or firms relying on cheap labour resources. Managing social budgets, empowering consumers and domestic markets all require a degree of oversight and fairness that the existing system cannot usually provide. This is particularly true of the financial reform, where a major argument against reform has always been that China's financial firms – banks, insurance companies and

brokers – could never withstand competition from foreign counterparts if they were not guaranteed resources. The speeding up of external investment – the so-called “going out” strategy – and a shift away from financial repression by the central bank and the finance ministry will diminish the resources available to China’s voracious financial sector.<sup>8</sup> In particular, the difference between deposit and lending rates for banks, their main source of income, will shrink.

The need to move away from an implicit dollar zone makes it unavoidable for China to have a real policy for its currency and interest rates, instead of delegating this to the US Federal Reserve and the US Treasury. China’s extraordinary financial expansion has relied so far on an external arbiter, saving it from tough political choices at home. Reallocating foreign currency reserves and lending, internationalising the yuan, and shifting to a consumer-based domestic economy that requires social budgets and stabilisers cannot be done with crude controls and the cosy relationship between the state, public banks, state-owned enterprises (SOEs), and their beneficiaries.

In the first few months of 2012, China has indeed begun to undertake these reforms. China’s central bank has published a new report that, against the logic of geopoliticians and vested state interests, calls for a lifting of capital controls and a shift towards convertibility.<sup>9</sup> While meeting with German Chancellor Angela Merkel in February, Wen also made clear for the first time that Chinese lending to Europe would not be dependent on the granting of market economy status and the lifting of the arms embargo. These concessions were not produced by Europe’s collective bargaining strength, which is at an all-time low, but rather by China’s strategic choice to prioritise foreign direct investment (FDI) in its key external markets and above all in Europe.<sup>10</sup> In March, the World Bank released a massive report on “China at 2030” that was sponsored and endorsed by China’s reformist Development Research Centre, a State Council unit. The report includes all the catchwords of China’s reformers, from the fight against vested interests to the notion of a top-down reform, and it argues that China’s growth will need to consider much more investment abroad, with a retreat of capital controls and a move towards reciprocity in investment with developed countries.<sup>11</sup> Perhaps for that reason, the report is controversial, and some Beijing think-tankers point out that it is underwritten by “one among several government units”.

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<sup>8</sup> On the “going out” strategy, see “China Analysis: Facing the Risks of the ‘Going Out Strategy’”, European Council on Foreign Relations / Asia Centre, January 2012, available at [http://www.ecfr.eu/page/-/China\\_Analysis\\_Facing\\_the\\_Risks\\_of\\_the\\_Going\\_Out\\_Strategy\\_January2012.pdf](http://www.ecfr.eu/page/-/China_Analysis_Facing_the_Risks_of_the_Going_Out_Strategy_January2012.pdf).

<sup>9</sup> On the internationalisation of the renminbi, see “China Analysis: Redbacks for Greenbacks: the internationalisation of the renminbi”, European Council on Foreign Relations / Asia Centre, November 2010, available at [http://ecfr.eu/uploads/files/china\\_analysis\\_redbacks\\_for\\_greenbacks\\_the\\_internationalisation\\_of\\_the\\_renmimbi\\_november2010.pdf](http://ecfr.eu/uploads/files/china_analysis_redbacks_for_greenbacks_the_internationalisation_of_the_renmimbi_november2010.pdf).

<sup>10</sup> On Chinese investment in Europe, see François Godement and Jonas Parelló-Plesner with Alice Richard, “The Scramble for Europe”, European Council on Foreign Relations, July 2011, available at [http://www.ecfr.eu/page/-/ECFR37\\_Scramble\\_For\\_Europe\\_AW\\_v4.pdf](http://www.ecfr.eu/page/-/ECFR37_Scramble_For_Europe_AW_v4.pdf).

<sup>11</sup> The World Bank and the Development Research Center of the State Council, *China 2030: Building a Modern, Harmonious, and Creative High-Income Society*, 27 February 2012, available at <http://www.worldbank.org/en/news/2012/02/27/china-2030-executive-summary>.

This alone deserves the attention of China’s partners. Europeans, for example, have been frustrated for years by the refusal of China’s government to even consider investment and public procurement measures. It has remained frozen in time – precisely at the year 2001, when China joined the World Trade Organization. The appearance under government auspices of a new stage for China’s economic reform could be a game-changer for its international partners.

In short, a shift in the economic situation, at home and abroad, has again made it more urgent for China to adopt a range of reforms across its economy and in its international economic relations. Bubble economics at home, limitless borrowing and investing by state actors and their proxy networks cannot go on. The prospects for hyper growth fed by the export engine and relying on a limitless capacity of global markets to absorb these exports have diminished. China’s prognosis of the American public debt situation has also been consistently sombre. Meanwhile, its judgments on the European situation, which were also very dark in 2011, have brightened considerably since the creation of the “fiscal compact” at the European summit in December 2011.

## The new reform agenda

Mainstream Chinese academics have come out publicly to support reforms and occasionally to denounce the opposition to reform by vested interests. In particular, Tsinghua University’s Sun Liping, a renowned sociologist who warned in 2009 that “decay” was more of a threat than “turmoil”, directed and co-authored a major report whose conclusions were publicised on 9 February by the *China Youth Daily* (the organ of the Communist Youth League and a main power base of leading cadres who are not “princelings”, it has generally held pro-reform views).<sup>12</sup> Sun denounces the hybrid nature of China’s mixed economy, which had encouraged vested interests that practise “official profiteering, restructuring of state-owned enterprises, the exploitation of coal and other resources, land development, property speculation, public listing of enterprises”.

Sun criticises the pursuit by the Chinese authorities of “hyperactive and malformed development”, an exaggerated preference for stability and the freezing of institutions during the transition period. Sun suggests that many Chinese have become cynical about reforms because these have often been captured by interest groups and have therefore become incomprehensible to ordinary Chinese. He discounts the familiar distinction made in China between left and right – the first advocating the use of power and the second promoting the market. In fact, vested interests and power-holders often use the market to enrich themselves: Sun cites the purchase of land at cheap prices and its resale

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<sup>12</sup> The original 9 February *China Youth Daily* article has been translated and published by the China Media Project at the University of Hong Kong. It is available at <http://cmp.hku.hk/2012/01/12/17967/>.

with huge profit margins, exposing what has been in fact a key financial ploy for local authorities in China.

Sun also urges China to “move in the direction of the mainstream world civilisation”, which is characterised by values such as “freedom, rationality, individual rights, market economics, democratic politics and rule of law”. Finally, he rejects as outdated the gradual, step-by-step approach to reforms based on the idea of “crossing the river by feeling the stones”. Instead, he advocates a “top down approach”, a term that figured first in the 12th Five-Year Plan, released in October 2010 when Wen was making his own pitch for political reform. The article summing up Sun’s report in the *China Youth Daily* is entitled “We Must Be Alert to ‘Becoming Obsessed With Feeling the Stones, to the Point Where We Don’t Want to Cross the River Anymore’”. Very rarely does an official media source criticise what has become a sacred formula defining China’s trajectory of the past decades.

The article on Sun’s report on the *China Youth Daily*’s website was soon removed. A week later, however, the *People’s Daily* ran an unsigned front-page editorial comment (i.e. one with great authority) that repeated some of Sun’s key points. It criticised cadres who had invoked “structural obstacles” against reforms, defended a “top down approach” and concluded that it is “better to have imperfect reforms than a crisis stemming from the absence of reforms”.<sup>13</sup> Thus, within the space of a week, a line of argument that appeared to have been killed off had reappeared in China’s official mouthpiece. An episodic and isolated campaign by Wen to put reforms, including political changes, back on the agenda is back at the centre stage of China’s politics. What has happened?

## Wukan and Chongqing

Evidently, the revolt by villagers in Wukan and the blow-up in Chongqing helped turned the tide in favour of reform. The protest in Wukan – where the first peasant soviets in China were set up in the 1920s – began in September 2011 following a land grab by the local authorities, a frequent occurrence in China. The villagers’ demand for new elections was not revolutionary. But what was exceptional was the cohesion of the village, helped perhaps by the fact that it only has seven distinct family clans. Like other “mass incidents” in China (there were reportedly 180,000 such incidents in 2011), village revolts are often put down. But, in December, Guangdong Party Secretary Wang Yang got involved and some villagers told journalists that senior leaders supported them. At the beginning of February 2012, the story had a happy ending when the leader of the protest was elected to be village leader.

Meanwhile, on 6 February, Wang Lijun, Bo Xilai’s security chief and close associate, entered the US consulate in

Chengdu, apparently seeking asylum. It remains unclear what prompted the move by Wang. He had earlier been represented by the Chongqing and national media as a daring and colourful hero because of his ruthless anti-crime campaign that resulted in the execution, among others, of his own predecessor in Chongqing. According to a purported “confession” that has appeared on the internet, Wang believed Bo was about to sacrifice his former associate as part of a deal. Bo had also made many enemies, some of whom may have got Wang to incriminate his political mentor.

In March, Bo was removed from his post in Chongqing. But in order to demonstrate its respect for processes over hasty decisions, the collective leadership will likely allow Bo – still a member of the Politburo – to limp on until the November 2012 Party Congress. Bo’s downfall weakens the central leaders who have reached out to him very visibly: that list includes at least Zhou Yongkang, the security chief, and Li Changchun, who is in charge of propaganda. It could even extend to Xi Jinping as well, who had made a laudatory trip to Chongqing in December 2010. Conversely, Hu Jintao, Wen Jiabao and Li Keqiang, as well as He Guoqiang, who is responsible for Party discipline, are strengthened by the event. Li Yuanchao, the party’s organisation man who has generally emphasised human resource management and competition, may also receive a boost.

So what next? Neither Wen’s liberal counter-offensive, nor the Wukan revolt, nor liberal reactions to the Wang–Bo saga are revolutionary in any sense. What has emerged is fear of a political regression to the mass movement politics of the Cultural Revolution (that is, the Mao era), a move to restart and implement legal and democratic reforms that often exist only in name, and a strong rebuttal of the forces of conservatism. Even “princelings” and their potential faction are not an issue raised publicly at this point, in part because there are split allegiances, in part because personal politics are dangerous in China.

One thing seems certain: it will be very difficult for the “core leadership”, increasingly seen as a blur at the centre of the collective leadership, to roll politics back. Certainly, the fall of Bo marks a swing away from the temptation of some to play with the People’s Republic’s old demon: mass campaigns, boasting and intimidation. But this has also set in motion liberal demands that will be hard to contain. The 550 million users of the internet and 350 million users of social networks have shown their influence repeatedly in a number of recent events: from the tainted milk scandal to the Sichuan earthquake, the Wenzhou train crash and many other human interest stories, or in the groundswell of expectant and ironic messages that followed the outbreak of the crisis in Chongqing.

None of these influences can morph easily into a movement, let alone an organisation, that could compete with the Communist party: it has seen to that. These waves of public opinion come and go, and the regime’s extensive surveillance of social networks lets them spread or puts them out, pretty

<sup>13</sup> “谈换届政德 Tan huanjie zhengde” (About the Political Environment), *People’s Daily*, 16 February 2012, available at <http://news.qq.com/a/20120216/000153.htm>.



much like brushfires. But, for the first time since 1989, there is the likelihood of a reform wing becoming active within the party.

The reformers' main asset – and curse – is that they channel critics and discontent within the party's goalposts as they did in the period between 1986 and 1989. We should never forget that China's reformers are peaceful, whereas conservatives and neo-Maoists have shown a disposition to shed blood.

Still, China's political climate has changed, and the economic issues under discussion also have no relation with what China was a quarter of a century ago. Wu Jinglian, the reform economist who advised market reforms from 1978 to 1989 before being sidelined, now explains that China has reached a crossroads: either it moves quickly forward, or it will regress to a planned economy run by crony capitalism and Maoism.<sup>14</sup>

## Why China matters to us

Cynicism often reigns in China. The distance between those who govern and those who are governed is such that divergent views at the top may seem inconsequential, given the brute strength and pervasive propaganda of the party-state. It is not yet possible to identify an organised reform faction at the top – Leninism, the ghosts of 1989 and permanent horse-trading inside the leadership still prevent that. Meanwhile, reform is opposed by well-organised vested interests – the military-industrial complex that has obtained double-digit budget increases year on year since 1989 (except in 1998 and 2009), the SOEs that have formed monopolies, the family clans at the top, the local bureaucrats transforming land into gold, and the security/propaganda apparatus which has remade a strong state.

Yet reform does not depend only on idealism. China's successes have created a twin crisis of expectations. Inside China, people who are now fed and mostly educated demand their rights and better social protection, and speak with such energy that this should clearly put an end to the Western myth that Chinese culture is married to authoritarianism. Internationally, the move to accommodate China into the international market and institutions has been replaced by calls for greater responsibility. The very size of China's economy, and its international impact, require international adjustments. The answers given to those new needs will depend greatly on the road that China takes.

In one direction, we find the vested interests opposed to reform that are entrenched in state-owned enterprises and rent-seeking monopolies. They are addicted to the low-wage, high-subsidy export economy. Their strong point is not

Westernisation as such but China's own "Go West policy", which is symbolised by Chongqing: it involves replicating far inland the Shanghai–Pudong formula that has brought together massive infrastructure, millions of low-paid jobs and imported technology. That policy requires a repressed national currency. And this, in turn, implies leaving monetary management to the dollar, which provides an anchor and a discipline without a need for efficient regulation in China. It has also resulted in extraordinarily high consumption levels for energy and raw materials in what is still a middle-income country.

Encouraging China to move in the other direction are the reformers. They represent the rising demands of an urban class with high education, the bevy of internationalised or smaller private firms with high-tech ambitions, and a push by labour to get a better share of the pie. By nature, reformers want to stop the haemorrhage of resources associated with excessive foreign currency reserves. They tend to price in resource and environmental costs. They need to create safety nets for the Chinese population, which in turn would end insane levels of savings. They want to reorient a share of China's past surpluses towards diversified international investments. Reformers have tried to retool China, with local elections, energy-saving urbanisation and a blossoming of civil society that put popular demands ahead of vested interests. A place to watch is Guangdong, which saw the birth of the first Chinese republic, nurtured the early special investment zones in 1979 and has generally supported political liberalism.

Although foreign policy styles do differ, conservatives and reformers are not neatly separated by their attitudes to the West. In fact, conservatives have a pretty nice thing going with America, inundating it with exports, then using it as a deposit bank and sending their children to acquire the foreign degrees essential to social prestige. They balance their attraction to joining the global super class with crude geopolitical competition. They share with American conservatives a dislike for surrendering national sovereignty to international norms and organisations.

By contrast, Chinese reformers have sought all sorts of partners for their experiments. Co-operation with Japan in the 1980s and with northern European welfare states in the 1990s preceded a long dry spell when China's model turned inwards. But reformers need to evade the competition between a rising China and US hard power. That means lessening the dependence on the US client and also its role as an outlet for excess savings. Europe – a huge market without a federal government, a fountain of knowhow and technologies unprotected against transfer, yet increasingly irrelevant as a hard power, particularly in the Asia-Pacific – is an ideal partner for reformers. They can experiment, acquire and transfer, and internationalise China's economy without coming up against America's big government. At the level of values, not all reformers may be devotees of peace, but they are attracted to international norms and a multilateral system.

<sup>14</sup> Wu Jinglian quoted in "The Age of Political Reform", *Caixin*, 23 March 2012, available at [http://english.caixin.com/2012-03-23/100371853\\_1.html](http://english.caixin.com/2012-03-23/100371853_1.html).

China's political turn, if it happens, has implications for Asia, for the West and particularly for Europeans. Since the days of Mao and Nixon, the establishments of China and the US have been fascinated with each other. The fascination has also produced strategic competition as China rises up the ranks of nations. But this has often favoured the harder element in China's leadership. It is the conservatives who have nearly destroyed China's Asian policy with their wide-ranging claims and tactical incidents in 2010. China's temptation to move back to regressive authoritarianism has also provoked a divorce with European public opinion.

The reappearance of a reform wing at the top of China's system would create a new economic opening, legal institutionalisation and political reform. Reformers in China will need a peaceful environment, not only for growth, but also to resist the pressure of nationalist and authoritarian currents or competitors inside the leadership. Europeans share with the United States a concern about the challenge these currents could pose. But they have perhaps even more stakes than the United States in a turn by China towards open multilateralism. The first step of that journey has begun with a resounding call in Beijing by China's outgoing prime minister, and with the stand now taken against a drift back to jingoist and mass movement politics. The next developments must be watched, and if necessary encouraged.

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