

# FROM DENG TO XI

ECONOMIC REFORM, THE SILK ROAD, AND  
THE RETURN OF THE MIDDLE KINGDOM

**SPECIALREPORT**  
SR023 May 2017





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# Preface

Yu Jie

**F**or many years now there has been an intense debate in the West about China, with wide ranging views being expressed about its economic system, its political order, and of course its foreign policy. Even its pop music and food culture have excited much interest. Whatever the field, there is a proliferation of opinions on the future of the 'Middle Kingdom' - 中国 Zhong Guo, or literally translated 中 Zhong - the central and 国 Guo - the state.<sup>1</sup>

Many serious writers have approached the subject of China in a fair-minded and balanced fashion. But many have not. Indeed, some have indulged in somewhat wild prognoses about China either ruling the world one day or collapsing under the weight of its contradictions. China deserves better, requiring grounded and nuanced analysis, not just crowd pleasing sensational headlines that paint a picture only in black and white.

With one-fifth of the world's population, China is more like a continent than a country. If the international community appears not to understand China's aspirations, its anxieties, and its difficulties some within the Chinese leadership may ask themselves, and some already are, why China should be bound by rules that were essentially established by Western powers.

China's foreign affairs continue to be shaped by the Middle Kingdom's history of 'humiliation' in the 19th and early 20th Century. There is also strong feeling that China does not get the respect that it deserves, the respect that many Chinese want from the international community.

The dangerous mixture of China's historical humiliation and its staggering economic success has unfortunately bred a strong sense of complacency on one level but an equally powerful current of hubris at the other. This could turn out to be a lethal combination inside China itself. Indeed, as some have been warning it might even lead (or rather mislead) Beijing into formulating its foreign policy in increasingly zero sum nationalist terms - a move that would not only be

detrimental to China itself but more importantly, to its near neighbours and other countries in the wider international system.

Deng Xiaoping's landmark reforms in 1978 not only built modern China, but also profoundly shaped China's view of the world and conduct of diplomacy. Deng's long-lasting legacy, as many of the contributors to this special report concur, was to create a paradigm shift in international affairs in the late 20th century in which China, unlike previous rising powers, will be able to rise peacefully.

One can only hope that this innovative strategy based on an innovative reading of the past and a belief that that peace is essential for China's future prosperity holds true well into the future. But the warning signs are already there, and Deng's approach of "keeping a low profile" looks like it might be being replaced by Xi Jinping's more proactive approach which seeks to promote Chinese core interests more forcefully while asserting China's 'rightful' status in global order. Whether China's bureaucracy and government is yet fully equipped with the skills or capacities to meet the new challenges going ahead remains to be seen.

After nearly 40 years of economic reform at home and a bold opening to the global economy during the 1990s, China is again at the crossroads and asking itself where it might be heading. Domestically, continuous economic growth has produced vested interest groups that refuse to give up their existing power and authority which, together with huge income inequality and appalling air pollution could challenge the very survival of the Party leadership.

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<sup>1</sup> The name by which China knew itself under the ancient emperors, emphasising the country's geographic centrality in their world map. In modern times the phrase has become a shorthand for a China with a rising international profile and central regional presence, as the Imperial dynasties extracted tribute and projected their economic muscles and military might in East Asia and afar.

Yet the rest of the world still has a profound interest in a reform-oriented China. The West may wish China could begin a transition towards a new political system. However, it is unlikely China will get a Western-style form of government any time soon. Moreover, even many of China's more vocal critics appear to recognise perhaps that a more turbulent China may not be an easier or more co-operative partner. But before we can arrive at any firm conclusions about the country and its future we would all be well advised to study it first: this LSE IDEAS Special Report is but part of a much wider conversation that needs to be had about the causes and consequences of the return of the 'Middle Kingdom'. ■

# Deng: Architect of the Chinese Superpower

Vince Cable

## DENG'S STATURE IN HISTORY

**I**t is no small achievement to have presided over an economic transformation which lifted hundreds of millions of people out of poverty and converted a poor, inward looking, totalitarian country into a global superpower. How much of this was Deng Xiaoping's personal achievement and how much credit should be deducted for his earlier complicity in Mao's disasters are matters that will be long contested. But few dispute that Deng was one of the truly great world leaders of the 20th century and one whose legacy is very largely positive in terms of human welfare.

The criteria for judging greatness are, of course, matters for debate. The present leaders of China are fond of marking their predecessors 'x% good, y% bad', thereby signalling their own priorities. It is difficult to believe that x could be much more than 0 for Mao Zedong who was estimated to have responsibility for the unnecessary deaths of 80 million people from man-made famine (on the estimates of Jung and Halliday), notably in the 'Great Leap Forward', repeated purges, and the deliberate creation of violent chaos in the Cultural Revolution. But political necessity – to legitimise the ruling Communist Party – has led to monstrous crimes being acknowledged only as 'mistakes' and Mao is still venerated by many. Deng's 'mistakes' are of an order smaller and his legacy – higher living standards, higher literacy, better health and personal security as well as a stronger China – massive and genuine. But there is a reluctance to accord him too much credit.

One factor is the old adage that success has many authors; failure, few. There were others like Liu Shaoqi who promoted radical economic reform sooner and more forcefully than Deng (Liu was denounced by Mao as the 'No 1 capitalist roader' in the Cultural Revolution; Deng was No 2). The reform programme was pushed through by leaders like Hu Yaobang and Zhu Rongji. There is little doubt however that Deng's guidance and overall direction was critical. He was the 'paramount leader' who modernised China.

Many Westerners are also disinclined to deify Deng because he never showed any interest in adopting Western democracy and, specifically, took the key executive decisions to suppress dissent in Tiananmen Square. His overseas (and some domestic) critics refer to his role earlier in his career as Mao's chief enforcer in the suppression of intellectual dissent in 1956–57. But

**"It is difficult to think of any political figure in history whose application of economic principles did so much to transform human welfare for the better."**

it is strange to criticise Deng for a failure to adopt a model he never believed in. He was committed to one party Communist rule and never claimed to believe anything else. He did however have a sophisticated understanding of the need for development and economic reform to be underpinned by strong institutions and long term stability which the Communist Party could provide. The experience of the former Soviet Union has done nothing to undermine this view, and the emergence of powerful populist movements in the West has also reinforced Deng's world view.

Historians will have to judge whether this broad approach (echoed in varying degrees by other Asian 'success stories' like Singapore and, now, Vietnam) is more durable than that of developing countries choosing the democratic, multi-party, road like India or Indonesia. What we do have, to date, is a formidable record of economic achievement since the Deng's reforms began 40 years ago.

**"He was the first Chinese leader for over 500 years confident enough to believe that China would not be overwhelmed or undermined by foreigners."**

My perspective is that of an economist concerned with applying economic ideas in the real world. It is difficult to think of any political figure in history whose application of economic principles did so much to transform human welfare for the better. Perhaps Franklin D. Roosevelt comes close, at least in the developed world. Neither of these men were economists or had any experience running companies (nor were other major economic innovators in the last century like Mrs Thatcher). Deng was a military man and then an administrator, a party apparatchik. His economic thinking was never set out in a detailed, coherent way and has been best preserved in simple, homespun metaphors reflecting practical common sense rather than original ideas.

He was fortunate in that China, in 1979, enjoyed favourable conditions for a massive economic transformation internally and externally. But as his biographer, Vogel, argues: "all the favourable conditions....would have been insufficient.... without a strong and able leader who could hold the country together while providing strategic direction." I now examine what that strategic direction was.

## **MARKETS AS A MEANS, NOT AN END**

A common misconception shared by Deng's Maoist critics and some of his western admirers is that Deng was, or became, a believer in capitalism rather than socialism. There is no serious evidence to support this view. Rather, there is a consistent thread, in his policy statements and actions, of a pragmatic willingness to try different techniques to improve the performance of the Chinese economy and raise living standards - building on the unified system of government under the Communist party established after the revolution.

His early career in the party hierarchy, following two decades as a revolutionary and successful general in the civil war, was as finance minister in 1953 and party secretary general in 1956, sixth in line of seniority. He was fully supportive of Mao's "socialist transformation" through collectivisation, nationalisation of large enterprises, five year central planning, and utilising Soviet technology to modernise industry. He was also Mao's hatchet man enforcing a purge of dissident intellectuals in 1956-57 including many scientists and technical staff

necessary for sustaining economic growth. And in the immediate aftermath of the revolution Deng was party secretary in the south-west where he attracted praise from Mao for his work on land reform (ie killing landlords). He was a loyal subordinate to a tyrant, Mao, but like Khrushchev under Stalin, was also an able, practical, albeit ruthless, administrator and manager rather than an ideologue.

Deng's practicality and Maoist ideology first came into serious conflict during the catastrophic Great Leap Forward when as many as 30 million people may have perished of hunger and related diseases in the period 1959-61, in what is now recognised to have been the greatest man-made disaster in the history of the world. Historians report Deng's expressions of regret that he did not do more to stand up to Mao over Mao's irrational utopian and brutal attempts at mass mobilisation as a means of forcing the pace of industrialisation. Out of loyalty, or fear, Deng did as he was told but as the full scale of the disaster became apparent he worked with Liu Shaoqi, the main internal critic of the Great Leap Forward, Zhou Enlai and Chen Yun to mitigate the damage and restore some semblance of economic rationality. Targets were relaxed. Peasants were allowed to farm and own individual plots of land, food requisitions were reduced, and some surpluses could be sold. Workers were allowed time to recuperate, not driven like slave labour, improving their productivity. Pay differentials were tolerated. Budgets for armaments, foreign aid and grandiose infrastructure projects were cut to create room for consumption and productive investment. Arguing for reform, Deng produced his much-quoted homily: "it doesn't matter if the cat is yellow or black as long as it catches the mouse".

While there is no evidence that Deng confronted Mao directly over the reforms, his card was marked as a 'capitalist roader' and when Mao had recovered sufficient political strength to launch a revolutionary counter offensive in 1966, Deng was a leading target. Unlike Liu, who died under house arrest, Deng survived the Cultural Revolution, spearheaded by Mao and the 'Gang of Four'. But he experienced years of exile from the centre of power, the persecution of his five children and personal humiliation through 're-education' and 'physical labour' until being gradually rehabilitated after 1973. During the period of exile many of his

ideas for future reform and restoring stability after the upheavals of the Cultural Revolution appear to have taken shape.

Deng began the process of modernisation in earnest in 1975 while Mao was still alive and it was necessary to clothe reformist ideas in Maoist language and to tiptoe around the Gang of Four. The first task was restoring order in particular to the army, the transport system, and universities. This work led to his dismissal and removal from power once again but following the death of Mao in 1976 he worked his way back and by 1978 was setting the agenda of the collective leadership. His priorities were already clear: domestic stability as a precursor to modernisation which included bringing in investment and technology from abroad, accepting that some regions and individuals would "get rich quickly" and widen inequality, rewards for those advancing science, technology, and productivity improvements, and decentralisation of decision making.

Deng's approach, for the next decade and a half, is perhaps best understood not in terms of particular policies or theories but in terms of a strategic approach which was long term, flexible, and decentralised and combined economic reform and modernisation with strong, unified government under Party control. One consistent theme was the need to proceed by experimentation, defusing hostility which would be provoked by a frontal assault and building up public support behind successful models: "groping for stones while crossing the river". All his experience of Maoist leaps into the unknown dissuaded him from the kinds of dramatic 'big bang' reforms attempted in the disintegrating Soviet Union.

Another principle was the need to set and pursue long term goals, free from the distraction of elections and frequent changes of personnel, like making China a middle-income country by the middle of this century (an aim which is likely to be achieved well ahead of schedule) or the long-term plans for raising education standards or phasing out loss-making state enterprises.

These goals and plans were all compatible with what Deng called 'socialism with Chinese characteristics'. 'Socialism' is a highly elastic concept but it remained central to his and the Party's legitimacy.

## OUTWARD LOOKING DEVELOPMENT

One of the most fundamental changes brought about by Deng was the ending of near autocracy, stemming from his belief that in order to develop economically China must draw upon the world's most modern practices in science, technology, and management and must therefore engage with the rest of the world through trade and investment. This approach had strong Asian precedents; the Meiji emperor (or rather, his advisers) had initiated reforms in the 1870s which led, with remarkable speed in historical terms, to the take-off of feudal Japan into an industrialised economy. China had a different trajectory. After a flurry of exploration in the fifteenth century, China turned inward and stagnated and such experience as it had of trade and Westerners in particular was on the receiving end of coercive, one-sided, agreements like those which followed the Opium wars. After almost half a century of upheaval, occupation and civil war, the Chinese Communist government under Mao adopted a policy of isolation to end the role of hostile 'imperialists' (which, increasingly, featured the Soviet Union after a period in which Soviet assistance and technology were encouraged).

**"In some ways, China's economic achievements have already exceeded his own ambitious expectations."**

Deng's early life abroad in France (where he first joined the Communist Party) and the Soviet Union gave him a more cosmopolitan outlook than the majority of Chinese leaders, like Mao, who had never left China. In the Soviet Union, he saw at first hand the NEP (New Economic Policy: an experiment in private enterprise and foreign investment under Communist party leadership). The NEP achieved impressive results until Stalin reversed it and Deng appears to have regarded the NEP as the economic model best suited to China (rather than Western capitalism).

After the death of Mao, there was wide recognition amongst party officials that China must learn from other countries and utilise foreign technology. Credit should go to Hua Guofeng, Mao's immediate successor who enthusiastically embraced the idea of opening China and sought to borrow ideas from 'reform Communists' in Eastern Europe, notably Yugoslavia. Deng was pushing on an open door. His first priority was to build up the science base by sending Chinese students overseas and encouraging foreign visitors and tourists. Then top officials were sent abroad to assess the potential for economic collaborations with the West (notably the Gu Mu delegation in 1978). Within months decisions had been taken to authorise overseas borrowing, launch an export based textile industry, and to lay the foundations for a more open approach to trade and foreign investment. A special economic zone was agreed for Shenzhen on the Hong Kong border.

In the decades that followed there was a consistent set of policies stemming from Deng's conviction that economies grow better when they remain open. He was the first Chinese leader for over 500 years confident enough to believe that China would not be overwhelmed or undermined by foreigners. Crucially he did not worry unduly that some Chinese students would not return or that foreign firms would compete successfully with Chinese enterprises in China. He was actually more radical in his thinking than the pioneers of Asian modernisation in Meiji and post-war Japan, South Korea, and later India which maintained strongly protectionist trade and investment regimes until very recently.

He was able to build confidence in this bracing approach by proceeding step by step with carefully prepared experiments in liberalisation starting with Guangdong's acceptance of foreign investment and special economic zones to facilitate exports, increasingly linked to Hong Kong, then Fujian, then Shanghai, then 14 coastal cities. There was inevitably political resistance as a result of the unintended consequences of liberalisation. One was corruption. But Deng was philosophical ("when you open the window some flies come in"). The reforms spread. There was also need to balance the freeing up of the coastal areas with policies favouring the impoverished peasants of the interior. Popular and successful rural reforms based on de-collectivisation and liberating households to produce for their own consumption and sale were introduced in parallel. One bonus was the unexpected emergence of TVE's, township and village enterprises, following the ending of Communes, acting as entrepreneurial small and medium sized firms and building up manufacturing and export capacity very quickly. There was a major check to Deng's reforms after 1984 when inflation seemed to be getting out of control and he had to backtrack on price liberalisation. But the setback was temporary. The process of opening continued, despite occasional setbacks, with spectacular success.

## THE RESULTS

Performance management was a key element in Deng's approach to government: decisions based on evidence rather than ideology, sensible targets and measurable results rather than implausible acts of collective will power, facts rather than what is now called 'fake news'.

Chinese GDP figures in the Mao years were often fictional: "statistics are a weapon in the class struggle", as one economy minister claimed during the Cultural Revolution. Deng insisted on ambitious but not ridiculous targets which were more ambitious than China's cautious planners thought possible (the 1981-85 plan target was 4 to 5%; Deng wanted to more than double that in order to achieve a quadrupling of production over the 20 years until 2000). Actual growth, even allowing for some

scepticism over numbers, was around 9% in the first period of reform: 1978-83. And it continued at that rate apart from a hiatus in 1989-90 when there was a reining in of budget deficits and inflation. But in the five years from 1991 growth averaged 12%: expansion unprecedented even in success stories like South Korea.

Deng's reforms had an immediate and major impact on the countryside. Grain production grew from 300 million tons in 1977 to 400 million in 1984, with bigger growth for meat and eggs. It is estimated that peasant income doubled over this period. Hundreds of millions of peasants were lifted above the poverty line while also providing a market for light industry, notably the TVEs whose employment grew from 28 million in 1978 to 106 million in 1992 when Deng stepped down; production grew 50 times in value.

Deng's policies of opening up the economy also achieved spectacular results. In 1978 China did little trade – exports were \$10bn, under 1% of world trade, but had grown to \$25bn by 1985. After continued rapid growth by 2014, China was the world's largest trading nation in goods (\$4.3 trillion). The continuation of Deng's reforms after 1992 owes, of course, a lot to the individuals who inherited them and built on them. But it was Deng who laid the foundations and created political and administrative structures within which his successors could operate.

In some ways, China's economic achievements have already exceeded his own ambitious expectations. He aimed for China to become a middle income country by the middle of this century but the IMF/World Bank estimates for 2015 suggest that on a purchasing power parity basis, China is not just the biggest economy in the world (with a GDP of \$19.5 trillion against \$17.9 trillion for the USA) but a middle income country with a per capita income of around \$12,000. This compares to \$53,000 in the US today and \$2,500 in China after the upheaval, material damage, and stagnation brought on by the Great Leap Forward followed by the Cultural Revolution – poverty levels of income. Crude economic measures are, of course, only one measure of the quality of life, but social indications like literacy and longevity tell a similar story.

The economic challenges faced by contemporary China are quite different in character from those which confronted Deng:

- the need for rebalancing from exports and investment to domestic consumption
- an accumulation of private sector, corporate, debt
- a more hostile international economic environment with threats of protectionism from a more nationalistic USA
- a demographic imbalance with an ageing population
- endemic and large-scale, as opposed to petty, corruption.

One very basic question which frames the answer to these challenges, and has remained since Deng's time, is how far the economic reform should proceed in parallel with political reform leading to more democratic institutions. Deng saw no merit in applying Western style democracy to China but China is now much more complex and economically developed, and other countries which achieved high levels of growth and development under authoritarian governments (like South Korea) have since democratised. Moreover, the other big Asian giant, India, whose development lags behind China and which maintains a multiparty democracy, has recently started to outpace China. That raises the question of the durability of China's model of political economy.

## DENG AND AUTHORITARIAN RULE

On most objective measures of achievement and betterment of the human condition, Deng should be regarded as a political hero, bar none. But for most Western commentators, and for many liberal minded Chinese, his record is blemished by an unwillingness to contemplate political, alongside economic, reform: an uncompromising belief that the Communist Party monopoly of power must be maintained, and his personal responsibility for the massacre of unarmed civilians which took place in Spring 1989 under martial law. Those issues remain very live since, on the one hand, China continues to make remarkable economic and social progress under a model of authoritarian government which Deng bequeathed

and, on the other, there is much evidence of localised dissatisfaction and unrest alongside an unsatisfied appetite for personal freedoms by many Chinese.

It is too soon to judge whether Deng's model will continue to deliver or to be clear what the alternatives are. What we can say is that the combination of economic liberalism and political authoritarianism did not arrive by chance or because it served Deng's personal self-interest. We know that it was the product of experience and careful thought over decades and that Deng had no wish to achieve personal gain or glorification; he was self-effacing, studiously avoided creating a personality cult like Mao, and appears to have had genuinely patriotic motives.

A thread running throughout his career and known beliefs is the need for order and the avoidance of chaos. The upheavals of 19th century China like the Taiping revolt, Japanese invasion, civil war, and the massive loss of life and impoverishment these caused: all stemmed from China's weakness and hence the need for a single-minded concentration on nation building and development. Chaos was also the consequence of political experiments like the Cultural Revolution which reinforced, for Deng, the importance of discipline and strong collective leadership.

A second strand to that argument was that 'China is different', not just because of its history but its scale. Deng could not see how elected representatives of different regions and places could reflect the strategic overview essential for long term development. India provides a partial rebuttal though and has thrown up two 'national' parties with, respectively, a unifying belief in post-colonial, socialist, and secular nation building and in the primacy of Hindu culture and religion. But, except at Partition, India has not had the experience of violent chaos and, until very recently, was outperformed by China on almost every economic and social indicator.

And linked to that argument is time as well as space: Deng's repeated belief in what we now call 'long termism', thinking and planning a decade ahead. India, like China, has had a system of five year plans but the kind of long term strategic approach Deng demanded has only happened under single party dominance. Had Deng been alive today he would have seen the

emergence of populists like Trump and the Brexiteers as proof of the unpredictable, volatile, opportunist nature of democratic leaders (as, indeed, the current Chinese leaders undoubtedly do).

It would be wrong to dismiss Deng's approach as in any way akin to that of the authoritarian 'strong man' like Putin or Erdogan. He was, as noted above, not interested in personal riches or glorification. He had a strong view, somewhat akin to Western economic historians like Douglas North, of the importance of deep institutional development – the rule of law, property rights, policy stability – rather than more ephemeral 'big bang' policy reforms.

To Deng the Communist Party potentially provided that stability and the rule of law, if not in a form recognised by Westerners. India, the only remotely comparable country, inherited a legal system and property rights and this has undoubtedly assisted the late flowering of Indian capitalism. But China was starting from somewhere else.

If there is a fallacy at the heart of the Deng Xiaoping's model it is the assumption of generally benign, disciplined, collective leaders rather than egotistical monsters like Mao. In the three and a half decades since Deng's death, that assumption has held. But it is not inherent in the model. ■

# Can China Rule the World?

Jonathan Fenby

**C**hina's emergence on to the global scene has been the single most important international event since the end of the Cold War. The process is far from over, and has taken on a wider significance following the increasingly political position taken by the People's Republic under the Xi Jinping administration. China is no longer simply an economic force but has become deeply involved in both regional and global affairs and has, most recently, set itself up as the champion of globalisation against protectionist tendencies in Washington. It has moved adroitly into vacuums left by the Trump administration even if its own record, for instance on trade, gives a particular twist to globalisation with Chinese characteristics.

The rise of the PRC and its ability to shrug off repeated forecasts of impending collapse have bred assumptions that the most populous nation on earth will come to dominate the 21<sup>st</sup> century or, as in the title of Martin Jacques' 2009 book, rule the world (though the author now says that this should not be taken too seriously). There are several reasons why this is wrong. To start with, no one country can dominate an increasingly fractured world. Nor does the leadership in Beijing aspire to do so; a stream of studies by Chinese think tanks pointed to the excessive ambitions of the Soviet Union, including its arms race with the USA, as a major reason for its collapse. China wants to be free to do as it wishes and to dominate East Asia, but it does not aim to extend its sway over the rest of the globe. If its leadership is convinced that American power is on the decline, this does not mean it aspires to global primacy. Keeping its own show on the road is quite a big enough challenge given the range of weaknesses thrown up by the post-1978 process of growing too far and too fast.

Talk of China resuming its imperial role is misleading. China was never a global power on the lines of Britain and France or the post-1945 USA. The Qing Empire may have accounted for third of the world's wealth around 1800, but its remit did not run west of the border with India and was focussed on tribute state system in East Asia. That said, it is clear that the PRC has shed the Deng Xiaoping policy of keeping its head down in foreign affairs while concentrating on domestic economic growth. For much of the period since the

paramount leader switched course in 1978, China was content to make the most of an international system dictated by others, even if it went its own way when it came to constraints such as protection of intellectual property. That has clearly changed, epitomised by Xi Jinping's global presence and, this year, by the attempt to head the defence of the open trading system.

Foreign governments have played along with China in their anxiety to profit from its economic clout, whether in commercial agreements or investment. Being upbraided by Beijing for 'hurting the feelings of 1.3 billion Chinese' is something they seek to avoid even if it means compromising their own values; the despatch of a letter signed by eleven countries in March 2017 protesting at the treatment of human rights lawyers or Angela Merkel's meeting with dissidents in Beijing are striking in standing out from the general kowtow adopted by governments when it comes to dealing with the last major state run on Leninist lines.

Ahead of the 19th Communist Party Congress at the end of 2017, the leadership has every reason to feel cheerful. Fundamental challenges remain, but the immediate objective of ensuring a stable progression towards Xi Jinping's second term at the top has been achieved, through a mixture of internal measures and good fortune from the other side of the Pacific. However, the nature of the system by which the People's Republic is run means that it will fall short of its potential and ensure that it will not come to dominate the world.

China has repeatedly disproved assertions that it is on the brink of collapse. Such arguments will not go away, but they have become less dogmatic in recent years, generally boiling down to statements that 'it can't go on like this for ever' with the implosion posted at some indefinite future date. Such generalities are of little value in seeking to assess where the PRC stands today and where it is heading during Xi's second term. As the leader has shown in the past four years, he is a pragmatist who proceeds in measured steps, using whatever instruments he needs to consolidate power for himself and the party he incarnates, be it blunt repression, ideology employed to try to impose uniformity, or cautious change designed to make 'China Inc' operate more efficiently. As things stand today, he and his colleagues have a range of reasons to feel reasonably comfortable.

Though imbalances remain pervasive, the economy is ticking over on a cyclical reflation path with sharp recovery of the producer purchasing price (PPI) index. Even if it is set to aggravate in absolute terms, the debt problem has been diffused for now by shifting it away from banks and local governments. Currency outflows have been regulated for the time being. The housing sector is heading for a correction not a meltdown.

Preparations for the Party Congress seem to be on track with no challenge to Xi, who may change the retirement rules to enable him to shape the leadership team as he sees fit, and, potentially, to open the way to a third term starting in 2022. Military modernisation is going ahead and the domestic security system is under tight central control.

Foreign policy is haunted by the uncontrollable 'Young Leader' in North Korea, a constant irritation for the 'Big Brother' in Beijing. But Donald Trump has pulled back on his initial questioning of the One China policy and his threat to declare the PRC a currency manipulator from the day he entered the White House. American China policy began in a confused fashion which can only serve Beijing's interests.

Following the Trump-Xi summit in Florida in March, the US President set out to try to strike a grand bargain under which Beijing would rein in Pyongyang and Washington in return would cut China some slack on trade issues. China's reaction - and whether it would be able to deliver on Pyongyang even if it wanted to - was unclear at the time of writing.

The PRC has scored serious points in the South China Sea. The Philippines has tacked towards Beijing, as has Malaysia. Vietnam has agreed to 'manage' bilateral differences. Cambodia is in China's pocket, meaning that the PRC can count on its veto of any hostile moves at ASEAN, where decisions require unanimity. The regional trading pact that China is promoting as an alternative to the now-discarded Trans-Pacific Partnership (TPP) is winning support. The Beijing-backed Asian Infrastructure Investment Bank (AIIB) is shelling out cash to Southeast Asian countries and the One Belt, One Road programme is moving ahead, notably with Pakistan.

**“The nature of the system by which the People’s Republic is run means that it will fall short of its potential and ensure that it will not come to dominate the world.”**

**“The attractions of China for those who overlook its fault lines have grown since Xi Jinping took the leadership of the country at the end of 2012.”**

Xi heightened his global status with his speech at the World Economic Forum in Davos putting himself forward as the champion on globalisation, even if it is clearly with Chinese characteristics. The passage in his speech on climate change and continuing the agenda of the Paris conference also struck a chord, especially in Europe.

China has always inspired awe by its size and the supposed superiority of its system of governance. Now, it is stepping into vacuums left by the Trump administration, its admirers overlooking the repressive nature of its political system and the ways in which it falls well short of the free trading hymn sheet from which it purports to sing. Apart from Xi's Davos speech and follow-ups by Prime Minister Li Keqiang, China has on offer an alternative to the failed Trans-Pacific Partnership (TPP) which would exclude the US and ease regulatory requirements on the environment, labour practices, and intellectual property protection in line with Beijing's core belief in the sanctity of national sovereignty. The PRC has launched the Asian Infrastructure Investment Bank (AIIB), the One Belt One Road (OBOR) initiative, the Silk Road Fund, and an array of bilateral aid programmes calculated to win friends in Asia, Africa, and Latin America along with investment in North America and Western Europe. All this has contributed to an image of China as the great global power at a time of uncertainty about the Trump administration and political turmoil in Europe.

If that leads to an over-estimation of the PRC's global position, there is nothing new in this. For many outside observers, and most of its own citizens, the world's most populous nation has always wrapped itself in mystery and myths. The First Emperor was not simply a ruthless tyrant who enslaved his people to execute his schemes of eternal glory but the founder of an imperial system that lasted for two millennia. Mao Zedong was not just a dictator whose machinations costs tens of millions of lives but the founder of a revolution with lessons for the world. In between these two fellow autocrats, the weaknesses of the Chinese system, its failure to modernise or to evolve an equitable political structure and its difficulties in engaging with the world at large were air brushed out of the image of an eternal civilisation in front of which the world should tremble.

If that picture was seriously damaged by China's decline in the 19th and early 20th centuries, it has been resurrected in our time by confident predictions that China will rule the world, that the 21st century belongs to the People's Republic, and that the country's supposedly meritocratic governing class surpass anything that messy Western democracies can achieve.

Much of this runs counter to important evidence from history and takes little account of the realities facing the present-day heirs to the imperial rulers in Beijing. But it feeds into a current of Western lack of confidence heightened by the democratic dislocations of populism in Europe and the United States. The attractions of China for those who overlook its fault lines have grown since Xi Jinping took the leadership of the country at the end of 2012. His promulgation of a 'China Dream' of national rejuvenation hits a chord at home and abroad.

His accumulation of authority has become the central feature of the evolution of the People's Republic since 2012. He has a dozen positions starting with the General Secretaryship of the Communist Party and the State Presidency which leads to him being dubbed his country's COE or Chief of Everything. Since reaching the very top at the end of 2012, he has pursued a carefully-orchestrated course aimed at strengthening the Party State which constitutes the prime mission he has defined for himself. This has gone through several sometimes overlapping stages of strengthening the Party and his own personal position using multiple instruments notably:

- the anti-corruption campaign
- tightening control of the armed forces and the internal security apparatus
- raising China's profile internationally with Xi making many trips abroad
- increasing the involvement of Party Leading Groups in domestic policy-making, notably in the economy
- Using preparations for the 19th Congress to usher in his second five-year term in office with a reshuffled Politburo and Standing Committee and a possible change of prime minister at the National People's Congress in 2018.

Despite the relatively benign short-term outlook for the economy, the global applause for China as the protector of globalisation (on its own terms), and for Xi as the anti-Trump, the PRC still faces manifold problems ranging from economic issues such as the build-up of debt and the danger of currency outflows to everyday concerns in the shape of air, water, and soil pollution, poor food safety, and a lack of accountability or independent legal system to give citizens recourse against officialdom. Tibet and Xinjiang remain restive. Taiwan is set of a path of autonomy with the DPP's election victory in 2016 marking the failure of Beijing's efforts to bring it back into the fold. North Korea is out of control. Japan remains a serious challenger for regional influence. Donald Trump's China policy is erratic with the potential for commercial friction to develop into a trade war and clearly divergent interests in East Asia.

The President's retreat from his initial position on the One China issue, along with the dropping of the threat to call the PRC a currency manipulator from the outset of his administration and the opening of a set of trade negotiations, appeared to add further support to Beijing's policy of adopting a cool response to his campaign rhetoric. The 2016 US election was instead portrayed by media in China as fresh evidence of the decline of Western capitalist democracy and, by inference, the growing power of the People's Republic.

Still the US retains huge potential, especially in innovation, where China has certainly made advances but where many of its leading new technology companies have prospered primarily by adapting American technology to their domestic market. The US remains the leading exponent of soft power, an area where huge spending by the PRC has brought few real dividends. The Chinese way of life has not spread as enthusiasts for Confucian values predicted, and those values themselves seem at odds with the reality of the system; 'do unto others as you would have them do unto you' has little relevance to the arbitrary rule of unaccountable security bodies.

Yes, there are hundreds of Confucius Institutes and classrooms round the world teaching Mandarin while the CCTV state network has opened international operations and China Daily publishes editions in Europe, North America, Asia, and Africa. But few people choose to adopt the Chinese way of life. Crowds demonstrate for democracy in the Middle East and Africa, but nobody turns out to call for the installation of a Chinese-style system of government. Those seeking to change autocratic systems are more likely to agitate for competitive democracy than for a set of hierarchical behavioural norms which, in the words of a 19th-century follower of the sage, stress "proper relationships, between ruler and minister, father and son, superiors and subordinates, the high and the low, all in their proper place, just as hats and shoes are not interchangeable".

A regime which cannot admit to uncomfortable facts in its own history and refuses debate on its assumed truths is hardly in a position to win intellectual support except from those whose appetite for the downfall of the United States was left unrequited by the failure

of the Soviet Union. The reasons Chinese give for buying foreign-made goods say much about the advantages products of other countries possess – their genuineness, high quality and safety, as well as their brand appeal. Walk the streets of a mainland city and you will see far more foreign influences, from clothes and magazine covers to fast food outlets and hair styles, than you will find traces of China in the West. English remains the global lingua franca – more people are learning it in the PRC than foreigners are learning Chinese.

Despite their country's increased prosperity, plenty of Chinese seek to move abroad. Apart from North America, Australia, and New Zealand, around one million Chinese are estimated to have gone to live in Europe this century, whether legally or illegally. Those who have done well from the system are among the keenest to move. More than 85% of millionaires responding to one poll planned to send their children abroad for education: Xi Jinping's daughter went to Harvard (under an assumed name) before returning home when the leadership started to denounce 'Western values'.

Popular warmth for China seems to be somewhat on the wane as global polls show rising disapproval rates for the PRC. Even in countries that sell a lot to China and have welcomed its investment in manufacturing as well as natural resources, reservations are surfacing. There are complaints about working practices at Chinese-operated enterprises, with violent clashes erupting in Zambia's copper belt, where the government took over the running of one such mine because of safety lapses. Chinese gold miners have been rounded up in Ghana. The Governor of Nigeria's central bank equated the way in which the PRC takes raw materials from developing nations and sells manufactured goods back to "opening up a new form of imperialism", while President Jacob Zuma of South Africa has spoken of trade patterns that are "unsustainable in the long term". Brazil has brought in regulations to limit Chinese involvement in domestic manufacturing. Some Australian politicians worry about PRC companies buying into their country's mining sector, and of the dangers of the currency becoming dependent on demand from the mainland.

For all its growth China remains, by its nature, a dependent power constrained by its reliance on imports of minerals (taking 80% of global supply in 2012), oil (it is set to overtake the United States as the biggest buyer in 2014), gas (as it seeks to reduce reliance on coal for energy) and, in the event of a bad harvest, food or animal feed. This is in striking contrast to the United States in its era of expansion. China has around 20% of the world's population but less than half that in arable land and renewable water and, as we have seen, both these vital resources are under threat.

Despite the importance of trade and Xi's talk of globalisation and openness, China operates, in many ways, a closed system protected by the Great Firewall online, import restrictions, oppressive state security, and a signature lack of immigration. American alliances stretch round the world, China has just one treaty ally - North Korea. China may become economically stronger than the United States in absolute terms (even if its citizens remain much poorer than Americans on average). But the political and economic equation looks different when one lines up America plus Japan. Plus India, plus the European Union with its 27 nation-states, including one major power in Germany and two substantial middle rankers in France and Britain, all allied to the US through NATO.

Significant as they are, these factors are not the prime reason for arguing that China will not dominate the world. The fundamental case stems, rather, from the nature of the political system set in place with the Communist victory in the civil war in 1949. Although there have been brief periods of liberalisation, the overwhelming motivation of those in charge since then has been the preservation, and, if possible strengthening, of Communist Party power. Xi has moved energetically both to put right the fragmentation of authority under his predecessor, Hu Jintao, and to reverse the devolution of administrative decision-making from the Party to the government preached by Deng Xiaoping. There is no reason to think that this centralising process will not continue in Xi's second term, or beyond if he chooses to change the rules to stay on beyond 2022.

The enormous material achievements of the last 35 years have not been matched by a corresponding development of the country's ruling ethos. It would be obtuse to deny the shortcomings of democratic states, but they have also shown a considerable ability to rectify themselves. The danger for the PRC is that the Communist Party straitjacket will inhibit the change the nation needs to continue its ascent. Reaching back into more than two thousand years of often mythical history is no great comfort in this respect, given the degeneration of dynasties. Rather than being a source of strength, the past is replete with pitfalls that the latest holder of the Mandate of Heaven in its Marxist-Leninist-Maoist-market incarnation would do well to avoid. Too many dynasties, including the last one, were lulled by their own power into refusing reforms needed to ensure their continued rule. So it may be today as the preservation of Party rule prevents the changes required to move the PRC to the next stage of development. Without a liberalisation of the economy, the installation of an independent legal system, the encouragement of the mindset that breeds innovation and a deeper international engagement, the risk for China is that it gets caught in what may be termed the 'middle development trap', in which it will not collapse but will be prevented by the leadership's desire to retain its grip on power in a traditional manner from evolving as it could were those inhibitions not so strong.

This will breed internal tensions with the expanding middle class whose aspirations are closer to those of upwardly mobile human beings anywhere than to behaviour patterns stretching back to the First Emperor and beyond. Technology means that Chinese can communicate with one another in an unprecedented manner. The Party State may seek to retain control of what its citizens say, but the size of the population makes this difficult to enforce and the mere fact of individual exchanges is a major liberalising step in the emancipation of thought. The traditional belief that the allegiance and deference of the governed to the governors take precedence over personal interests and ethics holds less and less purchase on citizens.

Xi Jinping's recourse to rule by slogans, complete with his 'mass line' and 'rectification' campaigns, study sessions and self-criticism, demonstrates how difficult it is for a hermetically sealed elite to adapt to the very process set in train with Deng's economic reforms at the end of the 1970s. Enthusiasts for the China model insist that the system is in a constant process of ameliorative change; the commentator and private equity financier, Eric Li, even suggests that the Communist Party is "the world's leading expert in political reform". Such a claim is difficult to credit except in terms of a ruling organisation which is constantly scrabbling to assert its authority and legitimacy. Its leadership faces a classic paradox: it needs to reform in order to rule more effectively, but reform brings with it the threat of weakening the system.

Strengthening land ownership rights to encourage modernisation of agriculture and liberalising the *hukou* residence registration system would each entail a relaxation of central control. There would have to be significant devolution of revenue-raising powers to local authorities since they would lose the ability to requisition and auction off land and, in cities, would have to provide for millions of new residents moving in from the countryside.

**"China's leadership faces a classic paradox: it needs to reform in order to rule more effectively, but reform brings with it the threat of weakening the system."**

Serious liberalisation of the financial system and interest rates along with major measures to cope with the debt mountain would put pressure on state owned enterprises which have been cushioned by a cushion of cheap money and subsidies. Opening up the capital account would lead to a flood of money out of China as people sought to diversify their holdings. Freeing the currency would expose the PRC to the ebbs and flows of the global market. Again, the control of the centre would diminish.

Introducing an independent legal system would expose vested interests of all kinds to prosecution and would bring an ultimate loss of control as the Communist Party would have to put itself under the law. Granting greater participation by citizens in decision-making, if not competitive democracy, would be a major shock to the system as it would open debate about the history and role of the monopoly political movement which asserts that it knows what is best for the people.

The challenge of such change would be all the greater because of the nature of the PRC, in which everything leads back to the Party State. Remove one or two bricks and the whole edifice could be at threat, or so the power-holders fear. The spectre of Gorbachev and the Bourbon monarchy is never far away. But if action is not taken, the regime risks growing steadily more out of touch with the population, and the world in which it has committed itself to live.

The result is a watershed which will determine the course the country takes in this decade and beyond. The accumulation of problems listed here are in a sense hardly surprising, given the extent of development and the priorities adopted since 1978, and do not, in themselves, point to the coming collapse of China given the resources of the Party State. But they are now piling up in a dangerous fashion and there may not be much time to deal with the combination of pressures. Decision making will be difficult for a leadership hemmed in by the cocoon of embedded Party rule. If reform is not undertaken in a far-reaching manner, the PRC will lurch from problem to problem, limiting its future development. If change is grasped, there will be slower short-term growth and a protracted period of difficult transition for the system built up since 1949. Either way, for all Xi's global summits and the projection of China through international programmes which will undoubtedly continue, these domestic factors will constrain the extension of the country's global influence as the leadership focuses on internal matters.

Domination of the 21st century is not in prospect when the prime concern will be to keep the 'China Dream' alive at home. ■

# China and its neighbours - the return of the Middle Kingdom

Gideon Rachman

**W**hen the process of reform and opening began in China in 1979, the country found itself in a historically unfamiliar and deeply humiliating situation. A state which historically regarded itself as the Middle Kingdom was strikingly poor and backward compared to its Asian neighbours. It was miles behind not just Japan and South Korea but also Southeast Asian nations such as Malaysia, Singapore, Thailand, and Indonesia.

Under these circumstances, China was forced to adopt a historically unfamiliar posture of humility. Throughout the first years of the policy of reform and opening, which began in the late 1970s under Deng Xiaoping, China made every effort to be friendly and co-operative with its booming capitalist neighbours. (Although it did fight a brief war with Communist Vietnam in 1979.) This policy of close co-operation and the avoidance of strategic rivalry even extended to its old wartime foe Japan. This pragmatic attitude was born of economic necessity. Japan was a valuable source of investment and expertise. And ethnic-Chinese entrepreneurs from Southeast Asia were often amongst the first to seek out investment opportunities in the new China.

The policy of friendship and openness to neighbours also had a strategic side to it. Deng Xiaoping and his successors were well aware that the outside world could take fright at the prospect of a rising China. And they knew that hostility from the outside world could disrupt China's economic rise. So it made complete sense to follow Deng's advice to "hold your position, hide your capacities, bide your time" - a dictum so famous that it is now often abbreviated into English as 'hide and bide'.

However, the appointment of Xi Jinping as general-secretary of the Communist Party in November 2012 looks increasingly like a turning-point in China's approach to the region. The era of 'hide and bide' seems to have come to a close. In the Xi era, China has become increasingly assertive in its relations with its neighbours.

Of course, the break with the pre-Xi era is not absolute. Even before Xi came to power, there were signs that China - fortified by decades of rapid economic growth - was increasingly prepared to take a tough line with its neighbours. In 2010 China's foreign minister, Yang Jiechi, had shocked some of the country's neighbours when, at a summit of Asia-Pacific nations in Vietnam, he had made the (now famous) statement that "China is a big country and other countries are small countries, and that's just a fact."

The fact that Yang Jiechi was then promoted under Xi to the more important post of State Councillor was, perhaps, an indication that the new Chinese president was comfortable with this more assertive nationalism. And, as president, Mr Xi swiftly provided evidence that he is willing to take actions that appeal to assertive nationalists in the government and wider Chinese society.

**"Economic and market power inevitably gives China political leverage over its neighbours - and there is increasing evidence that Beijing is prepared to use this leverage."**

**“The Chinese president is essentially seeking to return China to the traditional position it has exercised in Asia through much of its long history as the dominant regional power.”**

In December 2012, the month after Xi took over as head of the military, Chinese military aircraft entered Japanese airspace for the first time since 1958. In late 2013, China startled the governments of both the US and Japan by declaring an Air Defence Identification Zone (ADIZ) covering most of the East China Sea - including the disputed Senkaku-Diaoyu islands.

The most dramatic and eye-catching assertion of China's new willingness to flex its muscles in the region came later in the Xi period, with China's programme of 'island-building' in the South China Sea. In an effort to bolster its disputed claims to territorial waters hundreds of miles from the Chinese mainland, Beijing began to pursue ambitious land reclamation and dredging programmes that converted sea shoals into small islands. The construction of an airstrip on the evocatively-named Fiery Cross Reef helped to confirm suspicions in Washington that the artificial islands served a military purpose. The Obama administration attempted to push back against this development by conducting 'freedom of navigation' naval patrols near the artificial islands. But China had essentially created 'facts in the war'. The fear, in Washington and elsewhere, was that China is putting itself in a position where it could, one day, enforce a naval blockade on these waters. Any such achievement would give China a potential stranglehold on world trade given that (by Hillary Clinton's estimate), some 50% of the world's merchandise traffic trade passes through the South China Sea.

American disquiet at this development was confirmed when Rex Tillerson, Donald Trump's appointee as Secretary of State, suggested in his confirmation hearings in early 2017 that the US navy might seek to bar China from access to the artificial islands. This sounded like a formula for conflict between the US and China. But when the Trump administration subsequently backed away from this assertion, it seemed to confirm US impotence in the face of China's challenge in the South China Sea. This demonstration of Chinese might had implications not just for Washington. It was even more troubling for the other nations with overlapping maritime claims in the South China Sea - in particular Vietnam, the Philippines, and Malaysia. Increasingly, they began to fear that Beijing was intent on turning the South China Sea into a 'Chinese lake'.

Beyond the headlines, the underlying reasons for this new assertiveness by China in the Xi era are worth examining. They are both political and economic. The reforms unleashed by Deng Xiaoping had powered decades of rapid economic growth. In 2014, the IMF announced that, measured at purchasing-power-parity, China is now the largest economy in the world. The US remains the largest economy measured at market exchange rates - but even that title may go by the early 2020s. There are many other measures that also capture the increasing economic power of the People's Republic of China. The PRC is now the largest manufacturer in the world. It is also the largest exporter. China is now the world's largest market for vehicles, smartphones and oil. It is also the largest single market for most of America's key regional allies - including Japan, South Korea, Australia, and most of the ASEAN nations.

This economic and market power inevitably gives China political leverage over its neighbours - and there is increasing evidence that Beijing is prepared to use this leverage. In 2017, when South Korea antagonised the Chinese government

by deploying an American anti-missile system, known as Thaad, the Chinese government reacted by targeting the Chinese operations of key South Korean companies, such as Lotte. That same year Chinese premier Li Keqiang issued an unusual warning on a visit to Australia - telling his hosts to stay neutral in any disputes between the US and China. This was a remarkable proposal given the historic closeness of the US-Australia alliance, which had seen the Australians fight alongside the US in two world wars, as well as the Korean and Vietnam wars.

Any country that has accumulated the kind of economic muscle that China now has can certainly be expected to deploy it in pursuit of the national interest. But in the case of Xi's China, there is also a specific political and historic context that gives an added edge to China's new regional assertiveness. President Xi took power after twenty years of post-Tiananmen 'patriotic education', designed to convince Chinese students that the Communist Party is the essential vehicle to reverse the humiliations heaped on the nation during the 'century of humiliation' that began with the opium war of 1839-42. The central focus of the new nationalist rhetoric has been Japan, with a generation of school-children raised on tales of Japanese depravity during the war. As national leader, President Xi has positioned himself as the man who will now take the 'great rejuvenation' of the Chinese people to fruition.

This vision of a great rejuvenation goes well beyond attempting to reverse or avenge the humiliations inflicted on China in the nineteenth century. President Xi loses little opportunity to stress that Chinese history stretches back thousands of years - and to suggest that he and the Chinese government are heirs to the Song and the Ming dynasties, as much as to Chairman Mao.

This stress on the restoration of China's ancient glories has clear regional implications. It now seems evident that the Chinese president is essentially seeking to return China to the traditional position it has exercised in Asia through much of its long history as the dominant regional power, to which other countries must defer or pay tribute. As the American author Howard French puts in in his recent book *Everything Under The Heavens* "for the better part of two millennia, the norm for China, from its own perspective, was a natural dominion over 'everything under heaven'." In practice this meant above all, dominion over "a vast and familiar swath of geography that consisted of nearby Central Asia, Southeast Asia and East Asia."

This traditional Chinese aspiration had to be shelved for more than 150 years. From the beginning of its 'century of humiliation' in the mid-nineteenth century, China was humbled by powerful outsiders - first European imperialists and then Japanese invaders. Whatever the protestations of the party, Maoism clearly severely retarded the economic development of China and ensured that the country was in a weak position relative to its neighbours. But in 2010, China overtook Japan to become the second largest economy in the world. By the time Xi took power, China was finally in a position to attempt to reclaim its status as the Middle Kingdom - definitively displacing Japan as the centre of the Asian regional order.

The concerns in Washington about the rise of China are as nothing compared to the anxieties in Tokyo. This is not just a matter of proximity. The government of Shinzo Abe knows that the primary target of Chinese muscle-flexing and ambition

**"America's close alliance with Japan means that it is inevitably deeply implicated in the rising tensions between China and Japan."**

is not in fact the US but Japan. As Howard French puts it: "as China's self-regard has swollen, along with its newfound power, Japan has returned to the center of the Chinese gaze in the form of a bulls-eye." Much Chinese resentment of Japan is focussed on the Japanese invasion and occupation of the 1930s. But the roots of the resentment stretch deep into the nineteenth century - going back to Japan's annexation of the Ryukyu islands in 1879. These islands retain their significance today, as they include Okinawa - the site of the largest American military base in East Asia. The current focus of territorial disputes between Japan and China are the much smaller set of islands known as the Senkakus to the Japanese and the Diaoyu to the Chinese. But many Japanese fear that Chinese territorial ambitions will also eventually encompass Okinawa.

America's close alliance with Japan means that it is inevitably deeply implicated in the rising tensions between China and Japan. Some Chinese nationalists may hope that the US will eventually pull back from the Western Pacific and allow China an unblocked path to restoring its traditional sphere of influence. However they are likely to be disappointed. As Michael Green of the Center for Strategic and International Studies in Washington observes in his new history of American grand strategy in Asia and the Pacific

"if there is one central theme in American strategic culture as it has applied to the Far East over time, it is that the United States will not tolerate any other power establishing exclusive hegemonic control over Asia and the Pacific."

The election of Donald Trump raised the possibility that the US would enter a period of isolationism that might see it step back from this traditional commitment to "exclusive hegemonic control". But, after initial uncertainties, Trump appears to be returning to a more traditional US foreign policy. His pledge to 'make America great again' may run straight into President Xi's promise of a 'great rejuvenation of the Chinese people'.

The attitudes of China's Asian neighbours is likely to be critical in determining this struggle for power and influence in the Pacific. Japan's deep fear of a rising China means that the government in Tokyo is likely to cling closely to the American alliance. But many of the nations of Southeast Asia are likely to be susceptible to the mixture of economic opportunities and threats on offer from Beijing. China's most intelligent regional strategy is likely to be a modified and updated version of 'hide and bide', in which Beijing relies on economic rather than military power to create a modern version of the Middle Kingdom. ■

# China and Russia: Axis of Convenience or Strategic Partnership?

Michael Cox

“Appearances are deceiving. The self-styled ‘strategic partnership’ may look in the pink of health, but beneath the surface there are serious contradictions”.

Bobo Lo. ‘A Partnership of Convenience’  
The New York Times, 7 June, 2012.

**In this piece, I advance an argument that runs directly counter to the standard narrative promulgated by most experts in the West.<sup>1</sup> This narrative, simply stated, is that while it may seem as if there is a close relationship between China and Russia today, this only obscures the fact that there is more that divides the two countries than unites them.<sup>2</sup> As Bobo Lo has put it in a telling phrase, the relationship could never become anything but ‘convenient’.<sup>3</sup> In fact, his underlying argument – that the character, culture, history and interests of these two countries were too different for them to make common cause – is one which seems to have been adopted by most writers on the subject. Not only are the two rivals in Central Asia, and not only do they view globalisation somewhat differently, as the power gap between them grows Russia especially is bound to become increasingly anxious about China and China more assertive towards Russia. The West should therefore remain relaxed. As one seasoned observer has put it, “it would” of course “be very damaging for the US if Russia and China were to become something approximating to allies”. But there is little likelihood of this happening. There may well be all sorts of “reasons for China and Russia to get closer together” according to Geoff Dyer. But it is unlikely to happen. “They’re going to be as much rivals as they are partners” he concludes.<sup>4</sup>**

In what follows I want to question the view that rivalry rather than partnership characterizes China’s modern relationship with Russia. I do so not because there are no differences between the two. That would be plainly absurd. Rather I do so for a rather different reason – namely to explain what the various sceptics seem unable to: why it is that these two powers have managed to form an increasingly close relationship in spite of their apparently profound differences. This increasingly close relationship, I suggest, is rooted in history, reinforced by the authoritarian character of their two systems, strengthened by their opposition to western liberal ideas and bolstered by their resentment of the power the United States continues to wield in the world.

Naturally, this does not mean they do not have other interests, including in China’s case a very great interest in exporting as much of its capital and goods to the rest of the world. But this does not detract from the main argument being advanced here: namely, that China which has so few serious friends in the world today appears to have found something close to one in Russia, and that Russia - increasingly isolated from the West and in need of as much support as it can muster - has clearly discovered one in China.

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1 For an exposition of a view close to the one expressed in this essay see however Gilbert Rozman, ‘The Sino-Russian Partnership is Stronger than the West Thinks’, 11 January 2015. [http://www.huffingtonpost.com/gilbert-rozman/sino-russia-partnership\\_b\\_6140358.html](http://www.huffingtonpost.com/gilbert-rozman/sino-russia-partnership_b_6140358.html)

2 Rajan Menon, ‘The Limits of the Chinese-Russian partnership’, *Survival*, Volume 51, Number 3, 2009, pp. 99-130.

3 Bobo Lo, *Axis of Convenience: Moscow, Beijing and the New Geopolitics*. Washington D.C, Brookings Press, 2008, and his *How the Chinese See Russia*. *Russie.Nei*. Reports no. 6. IFRI. Russia,NIS Center, December 2010, pp. 1-30.

4 See Matthew Bell, ‘Should Washington be worried about a new Sino-Russian alliance?’ May 21, 2014. <https://www.pri.org/stories/2014-05-21/should-washington-be-worried-about-new-sino-russian-alliance>

## HISTORY

In most accounts of the China-Russia relationship 'history' is invariably deployed to explain why the two countries will forever be suspicious of the other. Yet history as we know is never one thing. And the alternative case could be made that there is a great deal that unites the two countries historically. The CCP after all was supported by the USSR throughout its history until the great split of the 1960s. Mao was an admirer of Stalin. And both fought together on the same side in World War II. But more than anything else, the one historical event that unites both remains the collapse of the USSR in 1991.

For Putin of course what happened in 1991 is what he has termed a "geostrategic catastrophe", caused in large part by Soviet leaders like Gorbachev losing control at the top while conceding far too much to the West

Unsurprisingly, this particular narrative is one that has found a ready audience in China. Always hostile to Gorbachev, and from the outset opposed to what they viewed as his dangerously destabilising efforts to liberalise the Soviet system (Deng later commented that even though Gorbachev may have looked "smart" he was in fact "stupid"), the Chinese agree with Putin that the easiest way to lose power is by conceding to the West and the most effective way of maintaining stability is by ruling with a firm hand.

Official China has drawn all sorts 'lessons' to make sure that what had happened to the Soviet Union did not happen to China. And what were these lessons? Quite simply that even if economic reform might be necessary, as it was in the USSR in the 1980s, one should make sure that this did not threaten the integrity of the state; and the second was that one should forever remain wary of the West's intentions especially when the West, as it tended to, dressed up its geostrategic ambitions in liberal rhetoric. Herein lays the most obvious lesson of all: namely that whatever else may have divided them in the past, and might divide them in the future, both states had a very strong interest in supporting the other against those in the West who challenged their sovereign right to rule in a particular way.

## HEGEMONY AND ITS DISCONTENTS

The lessons drawn from the collapse of Soviet power thus provided, and still provides, China and Russia with a common point of historical reference. But it was (and remains) the structure of the new international system, dominated as it was (and continues to be) by the United States that has continued to upset them most (and still does). Put bluntly neither feels that their interests, singly or collectively, are best protected in a system in which power is so heavily concentrated in the hands of a single 'hegemon', especially when that hegemon happens to be a liberal power like the United States of America. This not only flows from their very strongly held realist belief that hegemony confers great status on the hegemon, it also stems from the not illogical argument that the more power any other power has the less one is able to do oneself.

China and Russia's various efforts to challenge what they saw, and still see, as America's global pre-eminence has also brought both into direct opposition with what they view as something equally challenging: the western idea of 'humanitarian intervention', or to give its more official title, the international community's right to protect individuals when sovereign states fail to uphold certain basic norms. The story of course is not a simple one. Indeed, in theory, neither power is by definition opposed to the basic principles of the 'responsibility to protect' (R2P). That said, the two clearly feel deeply uncomfortable with the whole drift in western thinking which they insist allows the West to bring outside pressure to bear on what they see as recalcitrant states. This, they argue, not only undermines the UN system based on the original Charter of 1945 and the principle of sovereignty, it provides a green light for the West to force change from without on states with whom the West either happens to disagree with or whom both China and Russia may have significant economic and strategic relations. But this is not all. Their even greater fear, one suspects, is that if the democratic West is given the green light to change or overthrow dictatorial regimes in say Iraq, Libya, or Syria, this opens up the theoretical possibility at least of them legitimately demanding change in Russia and China as well. In this sense, their hostility to intervention is not just because they look at the world differently: it is because they worry that under the guise of advancing the rights of

the human, or protecting peoples from their less than perfect governments, the West could use the doctrine of humanitarianism as a Trojan Horse with the purpose of weakening their own control at home.

This would be less important of course if either China or Russia, or both, happened to agree with the kind of values that America and most of its allies have sought to promote over the past twenty five years. But this is clearly not the case. Indeed, viewed from the vantage point of Putin's Kremlin and or China's leadership compound in Zhongnanhai, the values publicly espoused by the West look deeply problematic. It is one thing doing business with the West. It is something else altogether when engagement with the West leads as the Chinese and Russians clearly fear it has, to ideological contamination.

The market may be neutral politically, but the West as a project is not; and faced with such a challenge the two countries together have taken different, but not entirely dissimilar, counter-measures. These have included in the Chinese case an extensive system of censorship reinforced in the age of the web by a massive array of controls over what they have defined rather ominously as 'information imperialism'. Russia may not have the same system of controls. Nevertheless, under Putin, the flow of information has been severely curtailed by a media that is now either completely state controlled or run by the friends of the President. Like the Chinese, the Russians have also spent an inordinate amount of time and effort trying to curtail flows of information from the outside world in an attempt to uphold what some Russians now call 'internet sovereignty'. Those close to Putin have even spoken of the West having launched what they call an 'information war against Russia', one which they have no intention of losing. Indeed, in one typically forceful statement (one of several) the Russian Foreign Minister not only linked US aggression back to the Cold War and an unreformed Cold War mentality, but to American exceptionalism and what he termed the belief by Americans that they possessed an "eternal uniqueness", one which allowed them to resist any form of external interference into their affairs but made it perfectly acceptable for them to become deeply involved in the affairs of others.

Finally, in this ongoing ideological battle against the liberal West, both China and Russia have tended over the years to identify any form of internal dissent with some assumed western plot to undermine their respective systems. In the case of Russia, the presumed link between opposition at home and the machinations of some unnamed western agencies is now regularly made in the media. Indeed, in 2014, a TV programme was put out (hosted by the same individual who allegedly murdered Litvinenko in London) purporting to show that there were still many traitors in Russia, all of them including a number of NGOs being supported by and therefore obviously working for the West. Others are portrayed in harsher terms still, most notably the Ukrainians who are now systematically portrayed in the wider Russian press as being little more than stalking horses for the Americans and their dangerous allies in Brussels.

China may have adopted a somewhat (though only somewhat) less bellicose approach. Nonetheless, in its own ongoing struggles against all those who would challenge the idea of the 'harmonious society' it has rarely, if ever,

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been reluctant to associate dissent at home with acts of subversion from abroad. Nor has it been backward in coming forward to sanction those in the West whom they deem to have overstepped the ideological mark – as Norway found out to its cost back in 2010 when the Nobel Peace Prize committee had the temerity to award the prize to the jailed human rights activist, Liu Xiabo. Whether or not Beijing viewed the award as a western plot remains unclear. What is clear is the impact it had on the official mind in China, reinforcing its basic belief that western countries (even small ones like Norway) were engaged in subtle and sometimes not-so-subtle forms of subversion whose ultimate purpose was political change in China.

## **WORKING TOGETHER**

If, as I have suggested here, China and Russia adhere to a broadly similar view of the world while together asserting their right to protect themselves from what they both regard as that bearer of ideological contamination known as the liberal West, how has their increasingly close strategic partnership manifested itself at the international level? Here again the by now standard answer is that in spite of a certain tactical convergence on specific issues one should not overstate the extent of their collaboration. Not only do big divisions remain. China has also become far too respectable - too much of a ‘stakeholder’ - to be drawn into an ever closer diplomatic relationship with its less than respectable neighbour. Especially when the neighbour in question has, it is argued, little to offer.

Indeed, in the midst of the crisis occasioned by Russian intervention in Ukraine, one respected western newspaper made a very direct comparison between the “constructive” approach being pursued by the Chinese and the “increasingly dangerous” approach adopted by the Russians. It is high time, the paper went on, for the “provocative” Russians to learn something from the more pragmatic Chinese.

Whether Putin ever read the advice coming from the Financial Times is of course unknown. But one suspects that if he had, he might have wondered why the editorial made no mention of the tacit support he was already receiving from the Chinese in his efforts to undermine Ukrainian sovereignty. He may have also noted that the editorial also forgot to mention the fact that in the years leading up to the Ukrainian crisis, the apparently ‘irresponsible’ Russians and the ‘well-behaved’ Chinese had been working increasingly closely together on a range of significant international issues in a number of key international fora.

The first, and perhaps most important, arena where China and Russia had been working closely together was at the United Nations where both occupied seats as permanent members of the UN Security Council. Their approaches were not identical. China appeared to be less willing than Russia to deploy its veto, usually preferring to use the less controversial strategy of abstention when faced with resolutions it opposed. Moreover, on some issues involving international security (Iran’s nuclear programme for example) China

was willing to support measures such as sanctions. Nonetheless, like Russia, it consistently resisted the use of force by the West against recalcitrant regimes if the purpose was regime change; and more generally, opposed any form of economic pressure being applied to states deemed to be guilty of human rights abuses.

The record speaks for itself. Thus in 2006, it effectively prevented any action being taken against Sudan over its genocidal behaviour in Darfur. In 2007 it then stymied the UN over Myanmar. And a year later, it acted once again to protect Mugabe's Zimbabwe from censure. But more was to follow when China with Russia together and repeatedly vetoed UN motions aimed to censure Russia's close (and only) ally in the Middle East, Syria. In 2011 for example, both vetoed a resolution condemning the Syrian regime's handling of anti-government street protests. A year later they vetoed an Arab League Plan calling for political change. Resolutions calling for sanctions against Assad were also vetoed, as was a UN draft resolution in May 2014 backed by 65 countries calling for the crisis in Syria to be referred to the International Criminal Court. And so it went on, causing something close to a storm in the UN and the wider Arab world. One writer even accused the two of 'kneecapping' the Security Council. But all to no avail. In fact, at a 2014 meeting in Beijing, the two both appeared to be congratulate the other for having prevented a western intervention which in their view would not only have made matters much worse, but would have undermined any moves toward a peaceful resolution of the conflict.

If increased political co-operation in the United Nations points to more than just a coincidental meeting of minds over specific issues, then China and Russia's formal membership of the sometimes underestimated - and often understudied - Shanghai Co-operation Organisation or SCO points to something of equal significance: a proven longer term ability to cooperate in matters relating to hard security. Of course, the SCO was not, and was never intended to be, the Eurasian equivalent of NATO. However, over time it soon became more than the sum of its disparate parts. A Chinese initiative in the first instance with the purpose of promoting some degree of regional co-ordination where before there had been none, the SCO has since its foundation in 2001 taken on several roles which now include a counter-terrorism function,

a sharing of intelligence, and an increasingly high degree of military co-operation – especially between China and Russia.

Initially, China was keen to stress that even if no western power was likely to play a role in the organisation this did not mean that its purpose was anti-western or anti-American as such. However, even if the SCO sought 'no open confrontation' with the US, it was difficult to think of the SCO not having some broader strategic purpose, especially after 9/11 when the US began to increase its presence in Central Asia. This certainly worried the ever sensitive Chinese, though given their own concerns about terrorism they were prepared to concede some temporary US presence. The Russians too conceded some US role for the time being. But as time passed, the Russian position changed. Indeed, the longer the US remained in Central Asia, the more concerned the Russians became with what they saw as an American attempt to establish a long-term presence in countries that had once formed part of the USSR.

In the end, things came to a head and in July 2005 when Russia managed to get its SCO partners - including China - to demand of the West and the US that they remove their forces from SCO members' territories. They in turn linked this specific demand to a wider debate about the kind of international system they sought and the role the SCO might play in creating a new 'world order', one in which no single power (here meaning the United States) would have a "monopoly in world affairs" or be able arrogate to itself the right to interfere "in the internal affairs of sovereign states".

Furthermore, at its various meetings China and Russia started to behave as if the SCO formed the kernel of a powerful new security organization constructed on principles very different to those found in the liberal and democratic West. Underwritten politically by what has become known as the 'Shanghai spirit' with its strong emphasis on non-interference, stability and diversity, the SCO thus soon came to form part of wider Chinese and Russian strategy, with the purpose of establishing deeper co-operation between the two powers. Of course, the SCO still only has a limited impact on the security situation in Eurasia more generally; and the organisation it is accepted has

been unable to “sustain or even execute many of the agreements it reaches at meetings due to conflicting national regulations, laws, and standards”. There are also ongoing complaints that some SCO members have so far been unwilling to ‘supply the collective SCO bodies’ with the resources necessary to make them function effectively. That said, a body which did not exist some time ago exists today; and it exists with the broad overarching purpose of allowing both Russia and China to find a united and separate voice in a part of the world from which they seek to minimize or even exclude the Americans.

If both China and Russia have invested much into maintaining and strengthening SCO as a regional security organization, the same could just as easily be said of an even more famous entity which started life back in November 2001. Initially, of course, even the idea of the BRICS was pooh-poohed by most conventional economists; and even after it had begun to take on a life of its own, there were still those who repeated the line that the countries who constituted the BRICS were just too different to be viewed as a united bloc. Even so, the simple idea of the BRICS not only helped redefine the way many people came to see the world - contributing in no small part to the notion that power was shifting away from the West - the BRICS themselves began to take on an institutional life of their own.

Something which had only started out as being an acronym gradually morphed into something more tangible following the financial crash of 2008. Certainly, since its first summit in 2009 the BRICS has assumed ever greater importance. Within the BRICS organization itself China and Russia have worked closely together fashioning common positions attacking in one breath western-style structural reforms, and then, in another, the unequal character of the world's financial system and the privileged role enjoyed by the US dollar. They have been equally vocal on global governance issues, arguing that the current distribution of voting power on the IMF and the World Bank is much too heavily weighted in favour of the Europeans and the Americans. But not only have they been strongly critical of the West. At the Brazil summit in 2014, the two also helped the BRICS establish two financial bodies (including one Bank) which would, they hoped, challenge the primacy of the International

Monetary Fund and the World Bank. Now whether or not these various efforts could ever weaken, let alone undermine the West's grip on the levers of financial power was not at all clear. Still, it was not without significance (or irony) that a body that had been invented in the West by a western economist, many years later looked like it was now providing both China and Russia with a platform from which they were able to launch rather effective criticisms of western practices.

Of course the BRICS, like the SCO, is still a work in progress. But in spite of the problems currently facing some of its members, what may once have been defined (and dismissed) as a mere ‘club’ has over time taken steps towards becoming something more. Perhaps there is no clear idea yet of what each of the five members want the BRICS to become; and there are real worries too about the current state of at least one of them, Brazil. Nonetheless, a body that was for the first few years of its existence virtually ignored or simply written off, has assumed a significance that few would ever have believed possible. Nor should we make the mistake (as some are now doing) of confusing the economic challenges facing individual BRIC countries today with its demise as a body.

Take China. It has no illusions about its own economic problems. Nevertheless, it would be quite wrong to think that it views the BRIC relationship as some sort of sideshow whose importance is bound to fade over time. If this were the case, it is difficult to understand why at the last party Congress it was picked out as one of the most important pillars in the creation of a more multilateral and multipolar world. It would also be impossible to explain why China more than anybody else has been urging other BRIC countries to play an even more active role within it. And it not just China alone. India too continues to view the organisation as an important vehicle, not only in terms of encouraging co-operation between the BRICs themselves, but also as a vehicle for enhancing its own international status. Russia is in little doubt either about the continued value of the BRICs both as an economic body, but even more significantly as a geopolitical counterweight to the West – one that also happens to confer upon Russia something which the West in its view never will: recognition as an equal in an international system in dire need of reform.

## CONCLUSION

The question then remains: how might the China-Russia relationship evolve in the future? The sceptics obviously think, and continue to insist, that underlying tensions will in the end make the relationship, whose significance they doubt anyway, either less important or undermine it altogether. But this is certainly not a view supported by the evidence at the moment.

Nor is there much to suggest they will be pulling apart any time soon. Indeed, why should they? After all, the relationship has already realised major strategic and political gains for the two sides. It has provided both with important diplomatic cover at crucial moments. It has led to increased political and military co-operation (if not a formal military alliance). And though there are still important problems in the economic relationship, it is worth recalling that whereas trade back in the 1990s was negligible, by 2016 China had already become Russia's single biggest trade partner and Russia an important source of energy for China.

More important still, the partnership permitted the two to confront together what both agreed was their biggest joint problem: namely, an American-led global alliance which not only tried to limit their ambitions, but put into doubt the very legitimacy of their respective regimes. Theoretically, things could change of course. For instance, the two countries could both adopt western style human rights reforms. Russia and China could come to accept the international order as it is. Russia could stop acting in the way it has been acting in Ukraine. The West could accept the annexation of Crimea. China could give up on its goals in the East and South China seas. It might even accept that the United States has a right to be an Asian power. But the chances of any of this happening are virtually nil.

The scene is thus set for a continued stand-off, one consequence of which will be to reinforce the belief in Moscow and Beijing that in a hostile international environment, one should stick close to one's friends (however imperfect they may be) because in an insecure world such friends (warts and all) are central to achieving what both are still striving to achieve: namely, greater political security at home, fewer obstacles to their ambitions in their own neighbourhood, and a more equal world system in which the United States and its allies have less control over what happens. So long as they continue to share these basic goals - and there is no reason to think these are going to change any time soon - there is every chance the two will continue to travel along the same, sometimes rocky, path they have been moving along together since the beginning of the twenty first century. ■

**“The SCO exists with the broad overarching purpose of allowing both Russia and China to find a united and separate voice in a part of the world from which they seek to minimize or even exclude the Americans.”**

# Expansion abroad, mounting challenges at home

By Guy de Jonquières

**“President Donald Trump has created a large geopolitical vacuum into which Mr Xi appears eager to move.”**

**F**ew recent events have brought home in more striking fashion how fast the world order is changing than the spectacle of Xi Jinping, China’s president, taking the stage at this year’s World Economic Forum to cast his government as an enthusiastic champion of globalisation, economic openness and multilateral co-operation.

Here was the supreme ruler of the world’s largest Communist country assuring the international capitalist elite that, as the US prepared to shed the mantle of global leadership that it has proudly worn for more than seven decades, Beijing was positioning itself to pick it up – and with it many of the principles for which the US long stood.

More paradoxically still, Mr Xi was, rhetorically at least, upholding those principles just when increasing numbers of disaffected voters in western democracies are turning away from them and throwing their support behind authoritarian populist politicians touting nationalist and protectionist agendas.

By attacking the foundations that have long underpinned US foreign and security policy – foreign alliances, rules-based global governance, and the provision of security and stability and other international public goods – President Donald Trump has created a large geopolitical vacuum into which Mr Xi appears eager to move.

But can China fill that vacuum, and does it really want to? And how genuine and soundly based is Mr Xi’s self-confidence

and outward display of strength, at a moment when Beijing is wrestling with a formidable list of problems and challenges piling up in its own backyard?

Until a decade or so ago, China abided faithfully by Deng Xiaoping’s long-standing injunction to bide its time and keep a low profile in international affairs. That changed with the eruption of the global financial crisis in 2008. That event shattered whatever respect Beijing still had for western leadership and prompted it to launch a series of headline-making initiatives intended to stamp China’s imprint and expand its influence around the world.

They include the Asia Infrastructure Investment Bank (AIIB), the drive to internationalise the Renminbi, and ‘One Belt, One Road’ (OBOR), China’s ambitious infrastructure project to link together more than 60 other economies. Meanwhile, Mr Trump’s abandonment of the 12-nation Trans-Pacific Partnership (TPP), which excluded China, has spurred Beijing to accelerate construction of a rival, all-Asian, engine of economic integration: the 16-member Regional Comprehensive Economic Partnership (RCEP).

**“True international leadership carries costs and responsibilities – financial, political, and military – in return for rewards that may not be readily apparent to domestic audiences.”**

In addition, after years of opposing global efforts to combat greenhouse gases and other threats to the environment, China has switched tack and is now posing as a stalwart defender of the Paris climate change agreement that Mr Trump has said he will pull the US out of.

However, borrowing some of America’s discarded clothes is one thing. Stepping into its oversized shoes and marching resolutely forward in them is another. The threat of US retreat from its global role is undoubtedly creating opportunities that China can use to expand its own influence. But China has yet to prove that it can replace traditional US leadership.

It is unclear, in any case, that that is what China really aspires to. Its rulers are well aware that true leadership carries costs and responsibilities – financial, political, and military – in return for rewards that may not be readily apparent to domestic audiences. In retrospect, it is remarkable that ordinary Americans were willing to shoulder those costs for so long.

In contrast, domestic priorities have long dominated China’s foreign policy. They, in turn, are governed by one overriding principle: doing whatever is necessary to strengthen and perpetuate its Communist Party’s grip on power. Accordingly, Beijing has taken an à la carte approach to multilateralism, embracing it when that has suited China’s own interests but otherwise tending to disparage it as a form of western domination.

As its decision to create the AIIB and its increasingly active role in RCEP suggest, that antipathy is starting to soften. So, too, is China’s long-standing aversion to alliances, as it recognises that winning friends and lining up support abroad is essential to influencing the global agenda. However, Beijing still has a long way to go.

The US was able to command the loyalty of allies because, even though they did not always agree with its policies, they trusted it to safeguard their key national interests. China, however, still suffers from a serious international trust deficit. Whatever it has gained through periodic charm offensives and lavish chequebook diplomacy abroad has been offset by anxiety and anger elsewhere in Asia at its public sabre-rattling and aggressive pursuit of disputed maritime and territorial claims in the region.

Equally, it has not dispelled other countries’ suspicions that some of its international initiatives are intended first and foremost to serve China’s own national interests. Such misgivings have led to tensions in the AIIB and aroused concern in some other Asian capitals that OBOR’s underlying agenda is to embed China’s political control over the region and to provide easy pickings for its companies.

Overcoming those doubts and bringing other countries to the table is made harder by the many deep geopolitical fault lines dividing Asia. Beijing’s relations with both Tokyo and Delhi have long been dogged by mutual antipathy and rivalry, as have those between Tokyo and Seoul. Bridging those differences in RCEP will test China’s diplomatic skills, as will India’s long-standing resistance to liberalising its trade policies.

**“The price of securing economic stability today may be still bigger economic problems tomorrow.”**

The driving force behind China's power is economic success. The country has risen at dazzling speed to become the world's biggest economy, its largest exporter and importer, its largest manufacturer and custodian of its largest (albeit recently dwindling) foreign exchange reserves. Its big market, the magnetic pull of its domestic demand, and its deep financial pockets have all endowed it with substantial leverage over other countries and propelled an eastward shift in the centre of global economic gravity.

However, China's economic motor is now stuttering. Growth, officially forecast at 6.5% this year, has steadily slowed and is increasingly reliant on continuing injections of credit, which is still expanding twice as fast as GDP, defying frantic government efforts to rein it in. The total debt-to-GDP ratio has almost doubled in a decade and is fast approaching 300%. Much of that borrowing has flowed not into productive investment, but into excess industrial capacity, asset bubbles, and an explosion of exotic speculative financial instruments. The Bank for International Settlements (the central bankers' bank) has sounded the alarm, warning that on its current trajectory China is heading for a financial crash.

Internationally, China faces the risk of a bruising confrontation with the US over trade. Though President Donald Trump has recently backed away from many of his campaign pledges to get tough with China by, for example, declaring it a currency manipulator and slapping a 45% tariff on its exports, it is unclear whether this is an armistice or a temporary truce. If open conflict did break out, both sides would suffer. However, as Mr Xi's advisors must be aware, China, as an economy with a sizeable external surplus, would stand to lose most.

Meanwhile, the sweeping 60-point economic reform programme promised at the third Party Plenum in late 2013 is treading water. Implementation has been piecemeal and patchy, and hard but essential choices in key areas, notably slimming down the bloated and inefficient state-owned enterprise sector, have so far been ducked. Some announced reforms, such as the Shanghai Free Trade Zone and Shanghai-Hong Kong Stock Connect have fallen short of expectations. Others, notably gradual liberalisation of the capital account, have gone partly into reverse as the authorities have sought to clamp down on accelerating capital outflows. Their actions have both cast doubts about further internationalisation of the renminbi and reined in overseas corporate acquisitions, braking China's ambitious drive to encourage companies to 'go global'.

Barring some sudden shock Beijing seems unlikely to change course soon, and certainly not before next autumn's crucial National Party Congress, which is expected to re-appoint Mr Xi for a further five-year term and to reshuffle the rest of the top leadership. The watchword until then is avoidance of any action that could trigger economic turbulence and, above all, a rise in the politically sensitive unemployment level. That has left economic policymakers treading an exceedingly narrow tightrope.

However, the price of securing economic stability today may be still bigger economic problems tomorrow. Increasing reliance on credit to maintain growth risks raising the debt mountain even higher, and with it the costs of the eventual cleanup of

the financial system. Even if a financial crash can be avoided, those costs are likely to weigh heavily on growth for years to come.

Optimists nonetheless believe things will change once the Party Congress is out of the way. Freed from his preoccupation with consolidating his own power, strengthening party discipline, and prosecuting his anti-corruption campaign, and with a new hand-picked team in place, Mr Xi will then be able to turn his full attention to dealing with the economy and to driving through the reforms they say.

Yet such arguments beg a number of questions. If, as has been widely suggested, Mr Xi is already China's most powerful leader since Deng, it is unclear why he should feel he needs yet more power in order to bulldoze obstacles to reform. Furthermore, the longer he defers bold action to address the country's economic challenges, the harder the task of tackling them will become.

It is also doubtful how aggressively he will actually tackle them when the time comes. The Third Plenum pledged "a decisive role for market forces" in promulgating reforms. That appeared clearly to imply a reduced role for the state in the economy. But will China's rulers really be prepared to step back from intervention - especially under a President who has sought energetically to tighten the Party's grip - when they have always viewed the right to control as central to their survival in power? That seems very far from certain.

Meanwhile, other, longer-term, challenges are mounting. China's labour force is shrinking, and its population is forecast to peak by 2030. That will mean fewer workers will have to support many more ageing people. Higher spending will be needed to meet the demands of China's expanding urban middle class for better schools, healthcare, and social services. And drastic action is needed to curb chronic environmental pollution and tackle severe water shortages in much of the country.

That is a daunting agenda, above all for a regime that has long based its legitimacy on delivering steadily higher living standards to its citizens. Implementing it will call for a huge commitment of financial and human resources, at a time when severe strains in China's creaking economic model are raising doubts about its future stability and wealth-creating capacity.

China's rulers have repeatedly displayed in the past an impressive ability to surmount daunting challenges. But rarely, if ever, have those challenges looked greater than they do today. Whether Beijing can succeed in addressing them effectively while simultaneously pursuing bold plans to carve out a bigger role on the international stage, or whether growing pressures and problems at home will oblige it to temper its global ambitions remains an open question. ■

# The Evolution of the Renminbi 2005-present: a market participant's perspective

Geoffrey Yu

**“It didn’t take markets long to figure out that selling the renminbi against the dollar was not going to be the trade of the decade.”**

**J**uly 21st 2005 was supposed to be one of the sleepier Thursday currency market sessions. No major data releases or central bank decisions were scheduled at noon so many traders were not at their desks. Those who were watching their screens were lucky enough to witness perhaps the most important central bank decision in a decade: out of nowhere the People’s Bank of China announced that the dollar-renminbi peg which had been in place since the late 1990s was to be abandoned and replaced by a tightly managed floating exchange rate regime, with a new fixing to be announced every day, starting at an exchange rate which allowed a nearly -2% appreciation in the renminbi. The Malaysian authorities announced the abandonment of the ringgit-dollar peg barely 10 minutes later. Global currency markets would never be the same.

Thus began the long road towards renminbi liberalisation, even though few people at the time – not least those inside policymaking corridors in China – understood what liberalisation actually entailed. For market participants (including the author who alas only made it back to his desk at 12:04pm on that fateful day in July 2005) the evolution of the renminbi’s status has encompassed four, sometimes overlapping, stages:

- the ‘teething period’ from the de-peg until the onset of the global financial crisis (2005-2008)
- the ‘long China’ trade due to strong growth and policy differentials between China and developed markets (2009-2013)
- the development of the CNH market and the adoption of ‘internationalisation’ as a strategic priority (2010-2016)
- the end of secular appreciation and the fight against capital flight (2014-present).

## **PHASE I: THE POLITICS BEHIND THE DE-PEG**

China’s successful defence of its currency during the Asian financial crisis was largely hailed as a stabilising influence in the region but by the mid-2000s it was become clear that the mechanism had outlived its purpose. The imbalances were becoming apparent, characterised by ever-larger increases in the trade surplus that translated into strong growth in foreign exchange reserves. What was a rainy-day fund to ward off speculators had morphed into a status symbol for mercantilist behaviour. However, the biggest problem was political: the United States’ current account position had begun to worsen, primarily driven by deficits with Asian exporters and the view from DC was clear – China was the biggest currency manipulator. If it refused to increase flexibility, other countries wouldn’t be able to follow lest manufacturing competitiveness was lost. Even exporters higher up the value

chain and the US' military allies such as South Korea and Japan felt the need to limit currency gains for the same reason.

The Bush administration made it known as early as June 2003 that it expected a change in China's currency regime and it had one major power of persuasion: the semi-annual Treasury report on the foreign exchange policies of the US' major trading partners. Created in 1988 under the Omnibus Trade and Competitiveness Act, it defines a currency manipulator as a country that has

- a significant bilateral trade surplus with the United States
- a material current account surplus
- engaged in persistent one-sided intervention in the foreign exchange market.

Once designated the President would be compelled to impose corrective measures. For several years the result was 'close but no cigar', yet politically Beijing realised it was on borrowed time. (As of the October 2016 report China remains on the 'monitoring list', along with Japan, Korea, Taiwan, Germany, and Switzerland.) Furthermore, within China there were also greater calls for currency flexibility as it was seen as a natural progression in financial reform.

The de-peg of 2005 was welcomed by China's major trading partners, the IMF, and others as an important statement of intent but it didn't take markets long to figure out that selling the renminbi against the dollar was not going to be the trade of the decade.

Although the peg had been broken, the People's Bank of China (PBoC) decreed a very narrow trading band of 0.5% around a central fixing to be published daily. This mechanism gave the PBoC two important levers of control: the fixing would guide the medium and long-term trend of the currency while the trading band, enforced by intervention and other forms of persuasion on the part of domestic banks, would limit intraday volatility which can sometimes cause any currency's movements to get out of hand.

Most importantly, and painfully for many traders' positions, there was no guarantee that there would be any alignment between the last trade of the current trading day and the fixing on the following day: everything was at the central bank's discretion.

Much to the frustration of the US and others, there were no further large one-off moves between 2005 and the onset of the financial crisis. In addition, the US was registering a period of rapid growth, which pushed interest rate differentials sharply in the dollar's favour. The gains in US purchasing power buoyed China's surpluses – the country's current account peaked at just under 10% of GDP in 2007, before disaster struck.

## PHASE II: CRISIS MODE

The global financial crisis essentially suspended any financial liberalisation. With the memories of the Asian financial crises still fresh, financial stability was paramount, even if this time the problem was not self-inflicted. Although the US was at the epicentre of the meltdown, markets' conventional 'risk aversion' reaction functions kicked in: flight to safety meant a surge in demand for dollars and developed market government securities.

Even though surplus emerging market countries had much better reserve provisioning (relative to external liabilities) compared to the late 1990s, a prolonged slump in global demand would challenge reserve holdings and potentially lead to balance of payments problems. Furthermore, as the global financial crisis triggered a major contraction in developed market banks' balance sheets, trade financing was badly hit. This meant that even where demand was present, the lack of credit meant that the wheels of global trade stopped turning, threatening the lifeblood of exporters. Images of fleets of cargo ships moored off Singapore became one of the defining images of the crisis. Not only did liberalisation grind to a halt but amid little fanfare Beijing re-established the dollar-renminbi peg in July 2008, and understandably complaints were scarce this time around: the world could ill-afford an emerging markets currency crisis to compound the situation across developed markets.

Amid the carnage, two extraordinary decisions were made, almost simultaneously, both of which would change the very structure of the Chinese economy permanently. Firstly, developed market central banks decided to engage in large-scale asset purchases, also known as quantitative easing. This left more than a fair share of funds for investment headed back to emerging markets in the 'search for yield'.

Secondly, China decided that it wasn't going to wait for the rest of the world fully recover and re-create the export jobs that had been lost during the crisis. In the second quarter of 2009 (after the annual National People's Congress session during which economic targets are set), the country decided to simply create its own internal demand by launching to this day what is considered the biggest credit stimulus in global economic history. Banks were given loan quotas and investment projects were approved en masse. Fixed asset investment (FAI) growth, which had held at a relatively stable level of just above 25% between 2006 and 2008, surged to well above 30% for the rest of 2009.

With growth and reflation came higher yields, and with the yield came the inflows of foreign investment. In June 2010, the PBoC announced that markets were once again to play a role in price formation and the dollar-renminbi peg started moving again – and of course the direction was weaker dollar, stronger renminbi. At this point, despite the de-peg, a long term bet on the renminbi appreciating in value (also known as being 'long CNY') was still not a trade which would give markets much joy. However, China's growth was a sight to behold, especially for the commodity exporters for whom China suddenly became its biggest customer: at one point it appeared that everything which could be extracted from Australia's earth and New Zealand's livestock was being shipped to China.

By 2010 China was the economic engine of the world but developed markets were starting to worry about sovereign debt yields in the Eurozone. The West's credit-driven economic model was fundamentally undermined and Beijing saw a once in a generation opportunity to push for global monetary and financial realignment: the era of renminbi internationalisation was about to begin.

**"China decided that it wasn't going to wait for the rest of the world fully recover and re-create the export jobs that had been lost during the crisis."**

### **PHASE III: GOLDBLOCKS INTERNATIONALISATION**

According to official statistics, China's economy grew by around 23% across 2009 and 2010. The current account surplus had come down, largely due to ferocious demand for commodities, but was still running at well above 3% of GDP in an expansionary environment. However, the renminbi only strengthened by around 3.4% against the dollar and actually weakened in real terms during the same period.

The external pressure on China to once again act on its currency policies did pick up but it was the change in domestic attitudes which perhaps made a bigger difference to the renminbi's status. The financial crisis (including the subsequent Eurozone sovereign debt crisis) led to reassessments of existing policies by all the stakeholders involved:

- the political leadership saw an opening for a 'multipolar' global financial regime and shift away from the dollar-dominated Bretton-Woods framework
- the People's Bank of China, facing the 'impossible trinity' problem of being unable to control interest rates, exchange rates, and capital flows, knew that importing the US Federal Reserve's ultra-loose monetary policies through the exchange rate was totally inconsistent with China's growth levels
- the State Administration of Foreign Exchange (SAFE – China's reserve manager) was already unimpressed with the low yields on its excessively large holdings of sovereign and agency bonds before the crisis and now had to worry about credit risk.

Outside of China, foreign investors were keen to expand operations in the world's biggest growth story and were eager to source renminbi in a manner which was more convenient to trade.

Despite these pressures there was little appetite in Beijing for a full flotation or sudden liberalisation in capital controls. Nonetheless, given the apparent demand for the renminbi, allowing the market a greater say in price formation was, at the time, a lower-risk option. In addition, China had in Hong Kong the luxury of possessing a separate jurisdiction with the ability to experiment. A fully liberalised currency is so much more than a floating exchange rate: capital markets in the corresponding denomination were perhaps even more important if China is to fully integrate its own financial system with the world's in the distant future.

Thus, the offshore renminbi market was born: the first prices of the new USDCNH exchange rate between the dollar and 'offshore renminbi' were quoted in August 2010, and in the same month McDonald's became the first non-financial foreign issuer of an offshore renminbi bond. By 2011, the terms 'CNH' and 'dim sum bond' had fully entered market lexicon, and renminbi deposits in Hong Kong had risen 10-fold from RMB60bn in November 2009 to above RMB600bn in August 2011. Additional liquidity came in the form of PBoC swap lines and the cross-border renminbi settlement capabilities of domestic financial institutions.

What was most notable about this phase of internationalisation and liberalisation was that for the first time, capital markets could become fully invested in the process, both literally and figuratively. The revenue streams from securities transactions and issuance was obvious, but the CNH was identified as a market in which the PBoC could not actively intervene and the exchange rate could adequately reflect market supply and demand, i.e. a tradable market which could become a profit centre in the same way as other developed market currencies.

In addition, given the arbitrage capabilities available, there was a perception that wherever CNH went, CNY could actively follow and perhaps accelerate its liberalisation and broader capital account liberalisation. Until then, despite sporadic widening of the trading

band, Beijing had continued to show very little appetite for changes in the onshore exchange rate regime. Plans were afoot for CNH to be copied as clearing windows were established around the world. The grand design was perhaps that one day, all the different iterations of offshore renminbi could be merged into one.

## **PHASE IV: ALL THINGS GOOD COME TO AN END**

In early 2014 the dollar- renminbi exchange rate was approaching 6.00 – a near 30% move in nominal terms and, according to the Bank for International Settlements ('the bank for central banks'), the renminbi had appreciated by over 40% in real terms. Questions over its sustainability had begun to appear. China's leaders were forthright about the need to rebalance an economy which had become dangerously addicted to credit and investment growth – the biggest and most pernicious legacy of the 2009 stimulus. As early as in mid-2012, Yi Gang, the head of SAFE at the time, had noted that in running a trade deficit the renminbi was "close to its equilibrium level". By then, China's current account surplus was already averaging below 2.5% of GDP, and in Q1 2014 it fell to 1.26% of GDP – the lowest on record.

There is no guarantee that a deteriorating current account position would weaken a currency (just ask the United Kingdom) but a confluence of factors were starting to erode confidence: developed markets were finally starting to reflate and in risk-adjusted terms the profits offered by Emerging Market currencies could no longer compensate for the risk. For China, the inevitability of slower growth was compounded by the realisation that a good deal of the credit build up was funded by external inflows: according to BIS data, external claims on China's financial system (ultimate risk basis) had surged from \$176bn in Q1 2009 to \$814bn in 2014.

During the same period, reserve growth had almost doubled to \$4trillion, much of which could not be simply accounted for by the trade balance. Such 'carry-specific flows' were far more flexible compared to 'sticky money' such as FDI and could be easily moved back out of China. As the Federal Reserve was beginning to talk up the prospect of rate hikes and growth continuing to slow, the renminbi started

**“Beijing’s perceptions of internationalisation and liberalisation changed and perhaps not for the better. Once again it came down to ‘control’, the loss of which was something the authorities did not particularly appreciate in practice.”**

to depreciate. In addition, the almost daily reports of big purchases of overseas assets by Chinese state-owned enterprises and how Chinese private sector investors were hoovering up real estate from Vancouver to Auckland rather than stoking domestic bubbles was a sign that something was amiss.

The PBoC welcomed the shifts as “holding reserves amongst the people” and a sign of maturity. However, in 2015 the dollar-renminbi exchange rate had once again stopped moving, yet reserves were falling, a sign that the central bank was intervening the other way: selling dollars to prevent depreciation. The FX market, never one to shy away from a fight against a central bank and having successfully forced the Swiss National Bank into abandoning its foreign exchange target for the Swiss franc against the Euro early in the year, smelled blood.

The ‘devaluation’ of the renminbi in August 2015 and the subsequent months of turmoil in the currency before the PBoC regained control was not wholly unexpected but it did mark a structural shift in market perceptions of the currency: it normalised and was no longer a one-way bet. Perhaps more importantly, Beijing’s perceptions of internationalisation and liberalisation changed and perhaps not for the better. Once again it came down to ‘control’, the loss of which was something the authorities did not particularly appreciate in practice.

To markets’ surprise, Beijing even found a way to control the CNH market by aggressively choking off liquidity to make it expensive for short-sellers to borrow the renminbi offshore. While such heavy-handed tactics were an important tactical instrument to enforce stability, over the longer term it eroded trust in China’s commitment towards liberalisation. These were crucial considerations in China’s efforts, despite the deterioration in sentiment, to incorporate the renminbi into the IMF’s Special Drawing Rights basket of major currencies and for inclusion of domestic markets into global bond and equity market indices.

After the ‘China crash’ fears stabilised in 2016, markets moved on, in this case to worrying about how Brexit and Trump once again altered the geopolitical landscape of developed markets. Beijing was perhaps happy to be away from all the attention amid its own leadership transition in 2017 but the intrinsic risks to the currency, especially in the form of domestic outflows, have not gone away.

As regulation would always be one step behind innovation, the ever-ingenious ways for households, private and even state companies to shift assets overseas turned into a losing game of whack-a-mole for the PBoC. Apart from the usual real estate deals, Hollywood studios and European football clubs suddenly became a must-have asset for Chinese companies and high net-worth individuals. Other channels for outflows from the crude (faux purchases of luxury items in Hong Kong) to the advanced (cryptocurrencies) demanded ever more-draconian capital controls to stem the flow and these efforts continue today.

## THE FUTURE

For most market participants who have been involved with the renminbi since 2005, the renminbi trade has always been a frustrating one, regardless of the direction. This is unlikely to change in the near future.

Other instruments and asset classes which were developed as a part of the process, from 'Dim Sum bonds' to the Hong Kong-Shanghai stock connect always seemed to be more style than substance, with demand for renminbi assets on the part of the international investor only pressing when both carry and currency appreciation were readily available.

Plans for offshore renminbi trading hubs have been replaced by clearing windows to which access is tightly screened and regulated. In perfect hindsight, Beijing's best opportunity to fully liberalise was during phase III, when global demand was plentiful and China had the growth to ensure that any adverse growth shock through rapid appreciation would have been absorbed more easily.

Now, with policy differentials moving against China and confidence in the currency at its lowest ebb, Beijing will likely defer any meaningful reforms for the immediate future. Under the current leadership, more control, not less, is the clear direction of travel. Whether exogenous factors such as rising protectionism and China's alleged assumption of the mantle of standard-bearer for globalisation and economic liberalisation can change Beijing's outlook remains to be seen.

One way or another, the journey has been one of disappointment: Beijing claimed to want to 'feel the stones to cross the river' when it came to liberalisation of the currency. After one too many slips on the stones, it seems the opposite bank is no longer that attractive and the traveller is thinking about turning around. ■

# From Deng to Xi: Leadership, Foreign Affairs and Who Decides Chinese Foreign Policy?

Yu Jie <sup>1</sup>

“A key reason why the West has overlooked the complexities of China’s foreign policy decision-making is the assumption that China is a static and authoritarian state where policy is simply dictated from the top.”

**C**hina’s staggering economic growth represents a paradigm shift in international affairs in the 21st Century. For the West, the current great power status of the Middle Kingdom offers a few cheers, mixed with many fears and frustrations. Deng Xiaoping’s long-lasting legacy has not only built the foundation of China’s tremendous economic success, but also profoundly shaped China’s view of the world and conduct of diplomacy. The subsequent generations of the Chinese leaders have diligently followed his view; and maintained a collective leadership of the Chinese Communist Party championed by Deng.

The rest of the world focus on the consequences, either intended or unintended, of Beijing’s foreign policy. While many remain puzzled by what China does and what China wants, very few understand who the key decision makers are and how decisions are being made at the Court of Zhongnanhai<sup>2</sup>. This decision-making process is not perfect, but has evolved over time since 1979. It is worthwhile to scrutinise the process with care if you want to better gauge the Chinese leadership and how it collectively decides foreign policy.

A key reason why the West has overlooked the complexities of China’s foreign policy decision-making is the assumption that China is a static and authoritarian state where policy is simply dictated from the top. This perception may have been valid under Mao, but is certainly no longer the case in the post Cultural Revolution China. Dramatic changes in the distribution of power within Chinese bureaucracies have been happening since Deng’s landmark economic reforms.

Chinese foreign policy has also expanded enormously in breadth and width since China joined the WTO in 2001. Certain policy domains, such as climate diplomacy and international financial governance, have only recently emerged as policy priorities for the Party leadership, and were irrelevant even during Deng’s era. These expansions mostly correspond to China’s rising international profile.

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<sup>1</sup> I am deeply indebted to several Chinese and European diplomats for their candid opinions.

<sup>2</sup> The official headquarters of the Chinese Communist Party and the Chinese central government.

As a result, almost all institutions in both the central leadership and local government are now involved in foreign relations to different degrees, and it is almost impossible for the various ministries to see China's national interests the same way or to speak with one voice. These differences confuse outsiders as well as many Chinese people.

It is important to remember that the main purpose of Beijing's foreign policy remains the maintenance of the Chinese Communist Party's absolute control and legitimacy to govern, and that economic and social stability is the paramount concern for the Party leadership.

This short contribution has neither the space to examine every key stakeholder in Beijing's foreign affairs, nor reflect on every change in China's foreign policy agenda. Rather, it intends to offer an 'inside out' sketch, to give a taste of how Chinese foreign policy is made. It will also examine the largely overlooked relationship between the Chinese Communist Party and key government ministries when foreign policy disagreements arise, and further illuminate some key changes since 1978.

## **THE CHINESE COMMUNIST PARTY (CCP) AND THE COLLECTIVE LEADERSHIP STYLE**

The CCP has an omnipresent role in every aspect of policymaking within the Chinese political system. Foreign policy is no exception.

The seven members of the Standing Committee of the CCP Politburo (SCP) and the State Council generally set key the strategic guidelines, or long-term policy goals, of China's foreign affairs; however, more specific policy measures are mostly made and implemented by the various governmental ministries and state owned corporations. The making of the Chinese foreign policy has become an increasingly crowded playground for various equally powerful stakeholders competing for their departmental interests, like in any Western democracy.

Vested interest groups have played a significant part in the Chinese political system since 1978. As Graham Allison argued in his interpretation of the Cuban Missile crisis, whilst the rules of game might play out very differently in a democratic elected government, the fundamental characteristics of bureaucratic competition remain the same regardless of the type of government (Allison, 1969).

Beijing's foreign policy formulation has become increasingly pluralistic compared to the one of Mao's era. A process of decentralisation in decision making has occurred since the 1978 Economic Reforms. As a result, there has been no single bureaucratic body that has supreme authority over the others when it comes to making certain decisions. Almost all bureaucracies and other players have utilised their resources and expertise to gain access to the highest level of Party elites in the search for more political clout and greater budgetary power.

Many old 'China hands' still dispute who makes Chinese foreign policy and why there are so many new institutions with obscure names proliferating across the Chinese foreign policy formation process. The answers to these questions are far from clear. Neither China observers in the West nor the home-grown scholars in China have

**"No single bureaucratic body that has supreme authority over the others when it comes to making certain decisions."**

given satisfactory responses. However, what remains unchanged is the ultimate decision making power of the SCP.

The changing leadership style of the Party has also contributed to institutionalisation of the Chinese foreign policy making process. The CCP leadership has evolved from what Charles Hermann defined as “a predominant leader” during Mao and Deng’s era to “a single collective group” proactively led by Xi Jinping (Hermann & Hermann, 1989: 363). Prior to Xi, Hu Jintao paid greater attention to formal institutions in policy making, laying a greater emphasis on proactive and pragmatic diplomacy and collaborating more closely with the then Premier Wen Jiabao.

Xi Jinping’s apparent assertiveness and emphasis on party discipline<sup>3</sup> has led many conclude that he is China’s most powerful leader since Mao Zedong, the man who led the Communist Party to victory in 1949 and who dominated the politics of the People’s Republic until his death in September 1976. Many pundits go further, seeing Xi as a new Mao<sup>4</sup>. Yet, this conclusion is too simple to draw and is certainly misleading in evaluating the Chinese leadership in the context of foreign policy making.

The CCP’s 18<sup>th</sup> Central Committee convened its Sixth Plenum on 24-27 October 2016 to address the issues of Party discipline and bestowed on Xi the status as the “core” leader of Central committee (People’s Daily, 2016). While designating Xi as the “core”, the plenum also reaffirmed the leadership’s commitment to the “collective leadership” system implemented by Deng Xiaoping in the early 1980s and developed by Jiang Zemin and Hu Jintao since (Deng, 1983; Xinhua, 2016).

Judging by the available evidence, Xi has not superseded normal Politburo processes as they worked under his predecessors Hu and Jiang (People’s Daily, 2002; Ibid 2012). As attested to by public appearances of members of the SCP, the key decision-making body, the division of labour amongst the team of seven - an intrinsic element of collective leadership that Deng championed - remains in a good order.

Upholding a collective leadership model has encouraged governmental institutions and certain powerful individuals both inside and outside the official policymaking process to find ways to influence the views of SCP members. A classic example is the direct access to SCP members enjoyed by the Party chiefs and CEOs at Chinese oil conglomerates namely, CNPC, Sinopec, and CNOOC. They share the same status as ministers in the central government and even more importantly, rank much higher than many ministers within the Party Central Committee (Downs, 2008; Garrison, 2009). A few state owned companies could well supersede many central government bureaucracies to ensure their voices are heard. Most of these powerful CEOs eventually find their way through the ‘revolving door’ and became provincial governors<sup>5</sup> or even members of the SCP<sup>6</sup>.

## **BUREAUCRACY AND DECISION-MAKING OF FOREIGN POLICY IN BEIJING**

Almost every domestic or external affairs decision made is based on a desire to achieve a consensus amongst the seven members of the SCP, even if such consensus is sometimes merely an illusion. This collective leadership model has provided a unique opportunity to those potential interest groups seeking to influence the opinions of SCP members.

These interests groups mainly consist of governmental institutions, Chinese companies, and to a lesser extent some foreign corporate conglomerates. They have fashioned strong advocacy abilities to shape the policy agenda based on their departmental preferences and corporate interests respectively. Importantly, none of current seven members of the SCP have much prior experience in foreign policymaking. The top leadership therefore relies on these interest groups for expertise in certain policy domains. This in turn has provided the relevant players with more channels and alternatives in which to mould Beijing’s ‘to-do list’.

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3 Please refer to a crucial speech made by Xi on the Sixth Plenum of the 18th Party Congress, accessed at: [http://news.xinhuanet.com/politics/2016-12/31/c\\_1120226008.htm](http://news.xinhuanet.com/politics/2016-12/31/c_1120226008.htm), also refers to “Seeking Truth, the Party’s main theoretical and policy journal, published a long excerpt, in 1st January 2017, from Xi given at the Sixth Plenum’s 27 October closing session

4 Please refer to other contributions of this special report

5 China Vitae, “Wei Liucheng”, accessed at: [http://www.chinavitae.com/biography/Wei\\_Liucheng](http://www.chinavitae.com/biography/Wei_Liucheng)

6 China Vitae, “Zhou Yongkang”, accessed at: <http://chinavitae.com/biography/37>

The ascendancy of China's State Oceanic Agency is an illuminating example. "Initially established as a scientific research institution for China's Antarctica explorations" (SOA, 2013) the SOA has in recent years gradually gained enormous power in various policy fields across government, from Chinese foreign policy to domestic energy policy. This is mostly due to China's increasingly sabre-rattling approach towards the South China Sea disputes. The SOA can provide scientific knowledge to inform the most senior Party leadership to formulate China's maritime strategy, while other established agencies dealing with foreign affairs have no such expertise.

It's important to acknowledge that the process of institutionalisation has not undermined the ultimate decision-making power of the SCP. The team of seven still deliberates on the most important matters. In particular, they take critical decisions on external affairs that relate to national sovereignty, territorial integrity, and potential military conflicts as well as issues with North Korea.

As confirmed by senior Chinese diplomats, issues within the domain of 'high politics' will only be decided by the SCP. Other policies such as climate change, trade, and international aid will be ranked by SCP members according to their perceived importance. The higher such an issue ranks, the more likely the related policy is decided by SCP members within a very short period of time. However, perceived significance of issues shifts over time according to the leadership's domestic and external priorities.

Besides setting broad policy priorities, the top leadership can determine the survival of any particular institutions. The Party can create a new bureaucratic framework, or assign and redistribute responsibilities and budgetary powers between existing agencies. However, such a restructuring process has not occurred on a regular basis.

What's more common are 'reshuffles' driven by issues and policy priorities. More often than not, an existing institution challenges the authority of any newly established organisation which may share competencies and budgetary powers. The Party will 'award' or 'punish' the challengers according to the situation and policy domains.

The authority that is given by the Party has often been coupled with responsibilities and budgetary powers those newly established institutions. However, certain policy domains have only recently emerged as priorities for the top leadership; for example, responsibility for curbing carbon emissions and developing renewable energy is shared by two different departments. Different bureaucratic stakeholders have to find ways to retain their share of power. The bargaining process "involves negotiation over resources among units that effectively have mutual veto power" (Lieberthal, 1992:9).

Since China joined the WTO, most Chinese foreign policymaking has required professional knowledge in areas such as financial governance, maritime technologies and climate change negotiations which are little known by most Chinese diplomats working in the Ministry of Foreign Affairs. They excel in foreign languages and diplomacy, but their lack of exposure to specialist knowledge hinders them in advising the leadership on these issues of new importance.

**"Almost every domestic or external affairs decision made is based on a desire to achieve a consensus amongst the seven members of the SCP, even if such consensus is sometimes merely an illusion."**

**“The more that is done today to engage and debate the Chinese foreign policy elite, the better the chances are for future policies that reflect the rest of the world’s interests and not just China’s.”**

As a result, there has been a surge of various re-branded institutions and individual entities that are not traditionally part of Beijing’s foreign affairs decision-making machinery participating in both policymaking and implementation processes.

The most illuminating example would be the National Development and Reformation Commission (NDRC). The NDRC remains the most powerful institution in Beijing’s central administration, if not the most powerful in China’s macro-economic policymaking in general. Its strengthened authority has inevitably undermined other institutions’ competencies and power in both domestic policy domains, as well as foreign policy. It gives input into almost every single item on top of Beijing’s foreign policy agenda: the Belt and Road Initiative, climate diplomacy, and negotiation of bilateral Free Trade Agreements with other countries. Yet, the top leadership has also restructured the NDRC three times within the last 15 years to contain its authority within an acceptable level (The State Council, 2013; Reuters, 2008; Xinhua 2006).

Xi’s ambitious ‘Belt and Road Initiative’ (BRI) (also known as One Belt, One Road) has encountered every single symptom of policy dis-coordination and no clear division of labour as argued above. At the moment, there are at least 15 different central ministries, including the NDRC, with authority to run the BRI - not to mention the financial and administrative interests of provincial governments and powerful State Owned Enterprises (Yu, 2017).

Some Chinese policy practitioners observe the foreign policy dis-coordination with greater nuance. Based on verdicts from senior diplomats in Beijing, governmental departments will only provide choices of policies for reference to the SCP members. It is overly simplistic to make a sweeping statement that one particular governmental department or state-owned enterprise prevails in Beijing’s foreign policymaking process over a long period of time.

SCP members are overloaded with other important domestic policy decisions to be made. External affairs have always been of secondary importance compared to the discussions on domestic issues during SCP members’ weekly meetings. As a result, most foreign policy decisions are taken by members of CCP Central Foreign Affairs Leading Small Group (CFALSG). A small leading group within the most senior policymakers is a characteristic Chinese solution for tackling difficult and outstanding issues.

Under the SCP, the CFALSG together with the PLA Central Military Commission are two equally important agencies in handling matters related to Beijing’s foreign relations (Jakobson& Knox, 2010). These two agencies are responsible for reporting policy proposals on external affairs for approval or objection to the SCP.

Submitting policy proposals offers a myriad of opportunities to all players in shaping the policy debate and outcomes. Many agencies have strived to create their own centres of gravity and shape the decision making

process. Most policy proposals have been carefully drafted and extensively discussed in relevant 'Divisions' and 'Bureaus' before the CFALSG members' meetings taking place. Ministers of the relevant departments finally have to present those proposals to the CFALSG.

In most cases, the CFALSG members do not object to proposals provided by relevant institutions unless there are major disagreements amongst the CFALSG members. When a disagreement arises, SCP members will facilitate candid discussion through a 'work conference' and make a final decision (Swaine, 2015).

Bland as its the name may be a 'work conference' is an effective, if not the most effective, vehicle to reconcile disputes within Beijing's foreign policy administration. Hosting a 'work conference' also signifies that the policy domain is being prioritised by the leadership.

## **THE EXPANSION IN CONTENTS AND SCOPE OF BEIJING'S FOREIGN POLICY**

Another key reason for such institutional power shifts is the expanding scope and increasing complexities of China's foreign policy. Beijing's agenda has evolved and broadened from simply maintaining amicable relations with its neighbours and other great powers to developing longer-term engagement strategies with Africa, the Middle East, and Latin America. China is also expected to become a major contributor to the global governance and international organisations.

Given its unprecedented economic growth and its rising international profile, the Middle Kingdom is seen as an indispensable partner for addressing global issues and an engine of recovery against the backdrop of ever-lasting global financial crises.

To meet the expectations from inside and afar, China's foreign policy agenda has incorporated what are traditionally considered as 'low politics' domains such as economics, global financial institutional reform, climate change, and foreign aid as integral parts of its foreign policy. As echoed by Prof Wang Jisi, a prominent advisor of China's foreign policy under President Hu Jintao, the idea of "Tao Guang Yang Hui" or keeping a lower profile is "a necessary component of Beijing's foreign policy, it is also insufficient" (Wang, 2011: 76).

China still has a lot of catching up to do in its approaches to the outside world. A main challenge to any future Chinese leadership will be how to develop a global foreign policy and respond to concerns in regions that are historically little known in China, but will affect and be affected by the country's economic growth. In order to improve its global diplomacy, China needs to draw on policies that go beyond the simple purposes of securing China's own economic interests.

It is important for outsiders to remember that China's foreign affairs are run by people groomed and trained within the current political system. The first generation of diplomats were mostly retired generals from the People's Liberation Army, followed by several groups of linguistic specialists from the Chinese universities. (Liu, 2002)

This continuity means that the more that is done today to engage and debate the Chinese foreign policy elite, the better the chances are for future policies that reflect the rest of the world's interests and not just China's. Chinese elites will remain aware of their difference to the rest of the world while adjusting to China's requirement to act as a great power, or "national rejuvenation" as Xi Jinping has advocated.

## CONCLUSION

While recent moves in Beijing's foreign policy have been significant and broad, it is also true that there remains substantial confusion over the foreign policy process in Beijing, in part generated by China's rising international profile and in part by a more proactive leadership style by President Xi himself (Xinhua, 2017).

Yet, the emphasis on collective leadership established by Deng Xiaoping still remains in effect among the team of seven. Crucially, "domestic stability maintenance" is the key priority of the Party leadership. Against the backdrop of the upcoming the 19th Party Congress, Xi wants to ensure his successful coronation by reducing any possible external tensions as far as possible. This ethos was certainly championed by Deng Xiaoping in the 1980s, and was carried out diligently by Deng's two successors.

Xi's attempt to fashion a more coordinated foreign policy with one voice is not an easy task, if not an insurmountable one. China in the 21<sup>st</sup> Century is not the ideology-driven Party-State in the aftermath of Culture Revolution in the late 1970s, insatiable for economic prosperity and openness.

Years of astronomical economic growth has produced vested interest groups that refuse to give up their existing power and authority together with huge income inequality, two trends that could challenge the very survival of the Party leadership. On the one hand, the need for further economic reform is as strong as it was in 1978. This requires a strong and safe pair of hands to lead the Middle Kingdom without going back to a state led by just one paramount leader like in Mao's era. On the other, a strong sense of hubris also derives from the complacency of China's economic miracle, which also pressures Xi to appear more muscular and to speak tough.

Xi clearly knows that he is facing a much higher level of political risk than either of his two predecessors after Deng in both domestic politics and foreign affairs. He needs to strike a fine balance that can satisfy both the elites and the ordinary public alike. He must also master increasingly fractious relations with China's neighbours and the great power from the other side of Pacific. Therefore, an effective and coordinated foreign policy decision making process is required to help him navigate the choppy waters ahead. By using his own words to conclude this piece and the entire report:

*"We will have the courage to crack the 'hard nuts', navigate the uncharted waters and take on the deep-rooted problems that have piled up over years. We must not stop our pursuit of reform and opening up—not for one moment."*

(Xi 2013) ■

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# List of abbreviations

<b>BRI/OBOR</b>	Belt and Road Initiative, or One Belt, One Road Initiative
<b>CCP</b>	The Chinese Communist Party
<b>CFALSG</b>	The Chinese Communist Party Central Foreign Affairs Leading Small Group
<b>CNH</b>	Offshore Chinese Renminbi
<b>CNPC</b>	China National Petroleum Corporation
<b>CNOOC</b>	China National Offshore Oil Corporation
<b>CNY</b>	Onshore Chinese Renminbi
<b>FAI</b>	Fixed Asset Investment
<b>NDRC</b>	China National Development and Reformation Commission
<b>NEP</b>	New Economic Policy
<b>PBoC</b>	The People's Bank of China
<b>PPI</b>	Producer Purchasing Price
<b>PRC</b>	The People's Republic of China
<b>RECP</b>	Regional Comprehensive Economic Partnership
<b>SAFE</b>	State Administration of Foreign Exchange
<b>SCP</b>	Standing Committee of Politburo of the Central Committee of the Chinese Communist Party
<b>Sinopec</b>	China Petroleum and Chemical Corporation
<b>SOA</b>	State Oceanic Agency
<b>TPP</b>	Trans-Pacific Partnership
<b>TVEs</b>	Town-Village Enterprises

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