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China and Shared Regional Prosperity: Five Risk Factors

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FINDING THE RIGHT approach to China is perhaps the biggest task for Japan and other countries in Asia Pacific. The sheer scale of China's rise leaves no doubt about its importance to shared regional stability and prosperity. At the same time, while stories of China's burgeoning economy abound, so do concerns regarding risks with the potential to derail its growth story. In particular, China faces five key risk factors that could turn those concerns into reality. These domestic and external risk factors are highly intertwined. As such, when engaging China we must pay close attention to how its domestic risks shape its external policy.

Short-Term Domestic Instability

An important pillar of the Chinese Communist Party's (CCP) political legitimacy lies in its ability to continue to foster economic growth and improve living standards. While China has enjoyed unprecedented economic growth rates over the past three decades, the days of 10 percent growth appear to be over. In the face of widespread bad loans, questionable shadow banking practices, and rapidly growing income inequality,

Chinese Premier Li Keqiang has been talking about retreating from economic stimulus policies and about deleveraging the financial sector and implementing structural reform in order to shift to a more sustainable pattern of development. Forecasters now predict China's growth rate will settle at around 7 percent. Simultaneously, China's new leaders must also deal with widespread corruption and environmental challenges, including food safety and air pollution, which have been a source of deep frustration for many people. Overall, China's current situation requires a fine balancing act between managing people's expectations for a good life now and the need to implement structural reforms to prevent future crises, as well as knowing how quickly and how far vested interests can be toppled without catapulting the system into a hard landing or worse.

Moreover, Chinese citizens are increasing populist pressures on the government by expressing their political frustrations online. As such there is the risk that President Xi Jinping will be tempted to use diversionary tactics, such as leftist mass movements

and an emphasis on nationalism vis-à-vis external hostile forces (including Japan and the United States), to distract the people from the CCP's governance shortcomings.

Long-Term Domestic Structural Challenges

China faces several long-term structural challenges that could affect its economic and political stability. For example, given the expected growth in China's middle class and Internet penetration rates, the newly prosperous and educated are likely to have greater expectations of the government and a greater capacity to exert pressure. Thus, for the sake of long-term internal stability, the CCP must proactively explore ways to give citizens legitimate channels to vent political frustrations rather than having them resort to unauthorized protests or making anonymous posts on Weibo, the Chinese version of Twitter. In addition, reforming the hukou household registration system—which restricts citizens of rural domiciles from sharing in the economic benefits accrued by the richer coastal areas—is crucial to addressing rising income inequality. However, for it to be successful it must be implemented in tandem with improved rural migrant access to employment, housing, social welfare, and education.

China also faces looming demographic challenges that are worsened by the fact that it will be the first country to get old before it gets rich. Repealing the one-child policy will help mitigate this, but potential gains are limited due to the lag in real changes to the population structure and the reality that many parents may still make the choice, for economic reasons, to have only one child. Hollowing out is also a risk to China's growth given that the rising cost of labor is leading companies to relocate factories outside of China to countries with cheaper wages. Moreover, corruption and political problems are prompting China's rich to emigrate in increasing numbers. China will need to break through the middle-income trap by moving up the production chain while also staving off a brain drain. Finally, the CCP's control of the education system, which is characterized by the institutionalization of patriotic education and a lack

of academic freedom, means that China risks not creating the human capital necessary to deal with future challenges.

“Core Interests”

China is in the habit of using the term “core interests” to refer to issues that it deems important enough to go to war over. Issues that the CCP has defined as core interests include disputes regarding Taiwan, Tibet, and Xinjiang and in recent years have at times been broadened to also include issues regarding the Senkaku Islands and territories in the South China Sea, as well as the border conflict with India. Regarding Taiwan, the current situation appears relatively calm, as the Kuomintang government under President Ma Ying-jeou has emphasized improved economic ties with the mainland through such measures as the 2010 Economic Cooperation Framework Agreement. Still, there is no room for complacency and the situation has the potential to change quickly. In Tibet and Xinjiang, the fact that separatist groups are facing off against the CCP's assimilationist policies means that there is an ever-present risk for riots to spark.

Applying the “core interest” label positions an issue as crucial to the CCP's pledge to protect China from repeating its past “national humiliation” at the hands of foreign powers and as such constrains the CCP's policy options. It is therefore crucial that other countries in the region be aware of tripwires that may force the CCP into a corner where it must take an excessively tough stance for the sake of its political legitimacy. At the same time, the region must work with China to encourage it to transcend its current domestic political dynamic within which nationalism exerts tremendous pressure on policy concerning what China considers to be its core interests.

US-China Relations

The US-China relationship is of utmost importance to the region. Relations between the two countries appear to be heading in a relatively positive direction, although considerable frustration remains within the US Congress due to the lack of concrete results. President Obama and President Xi's recent California

summit and the Strategic and Economic Dialogue that took place a month later saw the two countries discuss practical cooperation on issues such as the Korean Peninsula, cyber security, and a possible bilateral investment treaty. However, if not managed carefully, these issues could potentially become spoilers and undo the good work.

China has begun framing its relationship with the United States as “great power relations.” Xi appears to be promoting this conception of relations with the United States to the people of China as a new type of great power relations, or as trans-Pacific cooperation, in tandem with his call for a “Chinese dream” and “national rejuvenation.” The United States, however, is reluctant to go along with such lofty rhetoric, which may lead to an implicit acceptance of China’s conception of its core interests, and instead appears intent on adopting a pragmatic approach to cooperation focusing on concrete areas. So this positioning of relations can be seen as a double-edged sword. On the one hand, if referring to great power relations helps to satisfy Chinese nationalists at home and leads China to become a responsible regional stakeholder, it is a positive outcome. On the other hand, if such nationalistic politicking leads China to adopt an aggressive posture, pursue hegemonic actions, use force to settle disputes, and shun international norms, regional stability will be greatly undermined.

Coordinating North Korea policy is also a prickly issue. China is seen as a key influence on the North Korean regime. While Obama and Xi agreed in California that North Korea cannot be recognized as a nuclear power, and South Korean President Park Geun-hye’s trip to Beijing has seen a renewed improvement in ROK-China relations, questions remain regarding how far China is willing and able to pressure North Korea to commit to meaningful negotiations and ultimately to denuclearization. The extent to which a coordinated US-ROK-Japan-China approach toward North Korea is possible will be one measure of US-China relations and the potential for substantive big power cooperation.

Japan-China Relations

Japan-China relations have deteriorated to new post-war lows. In particular, the Senkaku Islands issue has put great stress on the bilateral relationship and undermined cooperation. Under the current circumstances, Japan-China relations can be seen as the most immediate risk factor with the potential to seriously jeopardize regional stability. From the Japanese standpoint, there appears to be no room for a compromise on the Senkakus given the clear historical records. At the same time, given the high level of nationalism that has been associated with the issue in China, the CCP will aim to avoid any impression of a compromise. As such, the only rational move under the current circumstances is an attempt to reduce tensions. With no immediate resolution in sight, Prime Minister Abe and President Xi need to sit down together and find the right plan to manage the issue so that it is not allowed to dominate the relationship and undermine substantive areas of cooperation. The decision by Abe to not visit Yasukuni Shrine on August 15—the day Japan commemorates the end of World War II—will hopefully help create an opening for positive relations between the two leaders.

The Japan-China relationship is critical to both countries as well as to the region given the two countries’ huge trade and investment flows, their economic complementarity, the interdependent nature of regional production networks, and their respective political influences. Moreover, as Abe seeks to push through the much needed third arrow of his Abenomics program—structural reform—to revitalize Japan’s economy, and as Xi seeks to balance China’s economic deceleration as part of the shift to a more sustainable pattern of development that still responds to public expectations of continuing improvements in living standards, neither leader can afford to allow disputes to undermine economic cooperation. A reset is needed immediately.

To this end, a strong political commitment is needed from both countries, including the espousal of a future vision for the relationship. Public relations measures to improve citizens’ understanding of the bilateral relationship beyond the Senkaku issue

and the removal of barriers to increased people-to-people exchanges are also needed. Moreover, the momentum generated by Japan's joining the Trans-Pacific Partnership should be utilized to accelerate negotiations of trade pacts that both Japan and China are party to, namely the Regional Comprehensive Economic Partnership and the Japan-China-ROK FTA. Finally, the region stands to accrue tremendous gains by launching intensive regional energy cooperation, especially through the East Asia Summit, and Japan-China cooperation in this area is key to its success.



The intertwined nature of these five risk factors means that they cannot be addressed in isolation of one another. If the CCP focuses solely on its domestic situation and merely reacts to external events as they unfold, it risks losing the opportunity to reap the benefits of economic cooperation that would in turn help

it to better address its domestic risks. On the other hand, if the CCP is not attentive enough to its domestic risks, it will increasingly feel the need to resort to diversionary tactics that malign the United States and Japan, further exacerbating its external risks. It is also important for Japan and other countries in the region to take into account all of these five risk factors, including China's domestic challenges, in formulating successful approaches to China. The manner in which China faces up to these risks—and the cooperation the region gives China in this process—will have long-lasting effects on the future of regional stability. If the region can get this tricky mix right it will cement shared prosperity for decades to come.

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