

The Asialink Chairman's 2010 Welcome Cocktail Reception

With Keynote Address by Professor Ross Garnaut AO:
“Relations with China as a great power”

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Ross Garnaut: Thanks, Sid, thanks, Jenny. I'm going to talk about China as a great power more than about our bilateral relations because that's the context of our bilateral relations. The world, including that part of the world which is China, is having some difficulty in getting its head around the idea of China as one of the two great powers.

It shouldn't really be so difficult because for most of the past two and a quarter millennia China has been the great power. The first time most of today's –what would once have been described as China Proper, came together within one state. The Qin Dynasty roughly coincided with the early stages of the rise of Rome.

The height of the Han Dynasty roughly coincided with the height of the power of Rome. At that time there were two great powers in the world. Rome was almost as extensive, populous and technologically advanced as the other one.

The Roman Empire gradually disintegrated; never to be put together again. The Chinese Empire did not. From time to time, China disintegrated as a state but was quickly brought together

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again--quickly in long historical terms--and a state resumed occupation of the old territory.

For most of the time since the Qin Dynasty, China has been the biggest economy on earth, and for most of the time the strongest state on earth. It was certainly the biggest economy and strongest state when George III sent Earl George Macartney as his envoy to the Emperor Qianlong in 1783 and suggested to him that there would be mutual advantage in close trade and diplomatic relations.

Qianlong considered the matter. There had been a little awkwardness about Macartney's reluctance to kowtow. But when that was all over, the emperor didn't stand on his dignity. He gave his considered opinion: Britain didn't have anything that China needed.

Well, it would have been wise for the Chinese leadership to treat more respectfully the upstart power from the island to the west of Europe. Just half a century later in 1840, when the emperor sought to exercise power over visiting British entrepreneurs and sought to stamp out the narcotics trade, the British House of Commons spent a whole night debating how they would respond.

Gladstone gave what Jenkins has described as his greatest speech to the Commons in the early hours of the morning, arguing that the defence of the narcotics trade was not a good use of Britain's rising power. But he was, just, a minority. It is said that Matheson and Jardine had bought half of the House.

Gladstone persuaded about half the House; but the other half was a bit larger. It followed that the British Navy sank the Chinese fleet at Canton and made the Chinese coast safe for opium from India.

1840 probably represents about the time when British economic power, under the influence of the great scientific and technological and economic revolution that had reached considerable momentum in the late 18th century, exceeded Chinese economic power and weight.

The rise of Britain had not taken very long. China took a long time to adapt to the rising power of first Britain and then the west more

generally. It felt so secure in its own superiority that it didn't, for a long time, feel challenged. China was different from Japan, which was smaller, weaker and more vulnerable.

Japanese learnt things about Chinese vulnerability, and about the vulnerability of the old Sinitic East Asian world of which Japan was part, from China's defeat in the first opium war. From 1840 there were groups in Japan. From that time, there were groups in Japan favouring accommodation with the new ways of the West, and recognising that absorption of the new knowledge--the scientific revolution, the economic revolution, the industrial revolution was going to be necessary for the preservation of Japanese sovereignty.

In Japan, people around the Shogun began to move towards accommodation of the new ways of the West. That occasioned what was at first a great reaction, which led to the restoration of the power of the emperor, the Meiji Emperor. The Meiji restoration, however, which began as reaction against those who wanted to accommodate the new ways of the West, quickly changed in character, as the young emperor and those around him came to the view that there was no alternative to absorbing the knowledge of the West.

So the Meiji restoration, beginning as a reaction against the productive new ways, became a movement favouring quick absorption of those ways. That destabilised the power balance in the old Sinitic world.

Up until the time of the Meiji Emperor, the relationship of Japan to China was one in which Japan held a respected but subordinate place in a Chinese world. The Japanese emperor would correspond to the Chinese emperor in classical Chinese, and would not be referred to as a barbarian.

Access to the new technology quickly changed Japan's position in East Asia and the world. From the 1890s, a rising Japanese power challenged Chinese power. But still China had difficulty coming to grips with the need to change. It had been such a successful

society, economy and polity for so long that it still felt no need to change.

It wasn't really until the success of the communist revolution that you had considerable acceptance within the society about the need for fundamental change. There was, of course, a big false start in the direction of change, dominated at first by ideas from the Soviet Union, notably central planning, which led to terrible failure.

Change in China only got on to its modern productive path some time after the death of Mao Zedong, in December 1978, when Deng Xiaoping secured the numbers in the Central Committee of the Chinese Community Party, and committed China to opening to the outside world and to market-oriented reform.

I recall the discussions I used to have with Rod Carnegie about all of this in the seventies, when Rod used to invite me down to Melbourne to talk to CRA's senior executives about economic growth in East Asia and its implications for resources development in Australia. I used to talk about how sustained economic growth in Japan, Korea, Hong Kong and Southeast Asia was changing Australia's economic choices and prospects. Before the reforms in China had happened, Rod was more confident than me that it was going to happen.

Well, the rest is history. China has been on what in retrospect looks an inexorable path of opening and reform since December 1978. There hasn't been any period since then in which economic reforms and opening went backwards.

There have been periods when internationally-oriented reform has moved forward faster. There was one period when the reforms were challenged, during which people who felt uncomfortable about market-oriented reform used the West's reaction to the Tiananmen massacre to seek to turn back policy.

But the reaction against reform in 1989 and 1990 failed, and was followed by a period from 1992 when the movement forward into internationalising the economy moved at its fastest pace.

The facts of Chinese reform and economic growth from December 1978 are now pretty well known. Average economic growth in China since then has been an average of almost 10 per cent per annum. Growth has actually fastest in the last decade, in the early 21st century, when the average has been over 10 per cent.

Well, when a populous country grows rapidly for a long period of time, it becomes a very large economy. That is what is happening in China. China will be the world's largest economy when its people on average are about one quarter as productive as the people of the United States. Who has had a lot of interaction with China, and thinks that the Chinese people for long would be on average less than a quarter as productive as people in the United States? So in the absence of major political instability, on a scale which would end rapid economic growth, which is unlikely but not impossible, then China is on a course soon to be again the world's largest power.

China's catching up with the average productivity and incomes of the world's most advanced economies from here will proceed more rapidly than you would expect simply from extrapolating the growth numbers. The faster catching up will occur because China is approaching what the Japanese economist, Minami called the turning point in economic development.

In the early stages of economic development in all of the East Asian economies, rapid export growth was based on an abundance of labour. Comparative advantage was in labour intensive goods. Rapid industrial growth was based on exports of relatively simple manufactures, using a lot of labour. This could keep going for a considerable while as labour came into the growing centres of economic activity from the countryside. The inflow of labour from the countryside kept wages relatively low, and for a considerable period maintained the competitiveness of simple labour intensive manufactures.

Japan reached the turning point at which there was no longer surplus labour in the countryside in the early sixties. Korea and Taiwan reached that point about one and a half decades later.

China is approaching that place now. In the emerging circumstances, we will soon go through a period of rapidly rising wages, a rising real exchange rate, and an acceleration of the catching up with the measured output and living standards of the most advanced economies—at least when measurement is in terms of the standard national accounts.

There's no reason to think that China's growth will slow down with rising wages in the early years after the turning point in economic development has been reached. Rapid economic growth can continue for a while, but it will be a different pattern of growth. Growth up until now, and especially the very rapid growth of the last decade, has been based on very strong export growth, and the highest investment and savings rate, rising over time, that the world has ever seen in any economy.

Consumption levels have been rising quite rapidly--probably more rapidly than any large economy ever--but not fast enough to absorb rising incomes. The wage share of income has been falling, and the profit share rising. A falling wage share has led to a falling consumption share—the other side of the coin to the rising savings and investment rates.

Most of the rising profits are saved and reinvested. The investment share of output has been rising. But even the rising consumption and the rising investment together have not been enough to absorb the growth in production. Huge and growing current account surpluses have been the consequence.

It was those current account surpluses that funded the debt driven booms in the United States, Australia, Britain and Spain in particular during the early 21st century, which were the precursor to the Great Crash of 2008 (see Garnaut, R. with D. Llewellyn Smith, 2009, *The Great Crash of 2008*, Melbourne University Publishing, Melbourne).

Many people say in response to China's surplus in current payments that China' has got to spend more on consumption—has got to consume more--to reduce the surpluses. However, the one thing that will reduce the surpluses is rising wages as labour

becomes scarce. The rising wages have started to happen, and will accelerate over the next few years.

Rising wages as labour becomes scarce relative to other factors of production will shift income from profits to wages. Consumption will rise, investment will fall and the pattern of growth will change. We will probably see an acceleration of what economists call total factor productivity growth in the overall economy, because rising wages will force more efficient use of resources.

Productivity growth has been extremely high in China and actually rising since the turn of the century. This is a completely different story to the Soviet Union right through its history, and different from a lot of other parts of East Asia.

High productivity growth will probably accelerate as wages rise, and economic growth will come more from productivity growth than from capital accumulation.

Sustained, rapid economic growth in China has seen a gradual shift in global power, because strategic weight is closely associated with economic weight.

Economic and strategic weight don't stay widely apart for very long. You can have large temporary divergence between strategic weight and economic weight. There was a considerable period when the Soviet Union had much more military than economic weight. But the economies of societies that over-emphasise military investment end up not being able to carry the load, leading to a marked deterioration in economic performance.

So there are strategic implications of China's continued rapid economic growth. I tell this story, as well as the story of Earl George Macartney and Emperor Qianlong, in the book, *The Great Crash of 2008*, that Melbourne University Press published last October.

The Great Crash has left a legacy of a seriously weakened Europe and a seriously weakened United States. The Great Crash has left crippling budget problems in these economies as far ahead as one can see. Economic growth in Europe and the United States will be

tepid at best for a long time into the future. At the same time, the financial crisis has left economic growth in China and other big Asian countries, India and Indonesia, relatively undisturbed.

The tectonic movements in economic and strategic weight that we have been seeing over the last several decades have been greatly accelerated by the financial crisis. There has been an acceleration of movement towards a quadripolar world in which there are four great powers. In this world, cooperation amongst four great powers will be necessary for the most important things to work in the international system.

The four emerging great powers are China, the United States, India and what I think will eventually be a more integrated European Union. The European Union does not look more integrated at the moment, but lessons will probably be drawn from the problems of contemporary Europe. The world that that is emerging will not work unless these four entities are broadly agreeing on the directions of international cooperation. There will be two greater powers within that four, the United States and China.

We've already had a couple of examples of how difficult it is to make the emerging international power structure work. We have all got a lot of learning to do. The Chinese are not used to the idea that what they do has a huge influence on the whole world system. The Indians are even further from thinking of their own actions being critically important to outcomes in the international system.

In neither China nor India have generations of people grown up thinking about the crucial international implications of their own countries' decisions. There has been little of the type of thinking about the international system that has gone on over the past sixty years at Harvard and Yale and Columbia Universities. There's no history of that yet in China. But it will come. Until the Second World War, there was little of this type of thinking in the great American Universities.

There is also a lot of new thinking to be done in the United States and in the West more generally about the emerging international

system. There is a lot of thinking to be done about how this new world will work. We haven't yet thought through what is necessary to make the new international system work. As a result, the world is not working very well.

Let me refer to a couple of examples of the international system not working well. We can see one example in the working of the global monetary system. I say in *The Great Crash of 2008* that the huge imbalances in international current payments that emerged in the early twenty first century were one of four causes of the global financial crisis. The monetary imbalances were necessary but not sufficient conditions for the crash.

The Chinese payments surpluses of the early twenty first century emerged when the United States set upon a course of greatly increased budget deficits and high levels of both public and private borrowing. Part of the background to the budget deficits was the fighting of two wars, without raising taxes to pay for them, at the same time giving large tax cuts. In a way, the economic policy framework under George W. Bush resembles that under President Lyndon Johnson in the sixties, except that Johnson didn't cut taxes.

It happened that there was a source of funding available for the American deficits of the early twenty first century. The East Asian surpluses, and over time increasingly the Chinese surpluses, were a response to the opportunity created by American policy. Chinese surpluses had not been particularly large before the early 21st century but the opportunity of increasing exports provided by the huge American deficits opened to them and Chinese businesses piled in.

On the eve of the crisis, China's current account surpluses were about 11 per cent of GDP. Imbalances on this scale contained seeds of instability. It would have required close cooperation between the United States and China for either of them to have got off the growth paths that underlay the large and growing imbalances. If the United States had decided unilaterally to tighten budgets--to reduce expenditure, raise taxes, and get its fiscal

affairs in order--then, if there had been no response from China to expand expenditure, there would have been global recession.

If China alone had sought to expand expenditure without a corresponding tightening of expenditure policy in the United States, there would have been rising global interest rates, and a destabilisation of the western financial system that was even more severe than that which actually occurred.

A good outcome for both countries required China and the United States to get together and agree on expansionary policies in China and contractionary policies in the United States. There was never productive discussion.

We still haven't seen productive interaction between China and the United States on these issues. I sat next to Zhou Xiaochuan, the Governor of the People's Bank of China, at the Reserve Bank's 50th birthday dinner last week. The Governor expressed his concern that if America went back to expansionary ways, and was able to find a way to continue to fund government deficits, then China would be tempted to go back to reliance on export-oriented growth.

Another example is climate change. China and the United States are by far the world's two largest emitters of greenhouse gases and China by far the most rapidly growing emitter of greenhouse gases. There will be no global solution without cooperation between the two of them.

We saw at Copenhagen that we haven't yet begun to find a basis for cooperation in the new world.

For us, we Australians, the adjustment to China as a great power is challenging in some special ways. The period of white settlement in Australia roughly coincides with the period in which English speaking people dominated the seas and from about 1840 the world.

We are used to having as a protector, as a big brother, the toughest, strongest boy on the block. That's lead us into certain habits of mind which will need some adjustment in the new world.

When Russia ran into Britain in the Crimea in 1863, *The Sydney Morning Herald* ran an editorial: "we warn the Tsar". That is what you do when you are confident of the protection of the big boy on the block.

When our English speaking big brothers are no longer the biggest boys on the block, we will need to be more clever and more subtle to achieve strategic objectives.

What will China be like as a great power? Well, China is used to being a great power and for Chinese, it will feel like a return to the normal order of things.

Chinese will feel quite comfortable about their country being a great power. China will actually be less scratchy as a great power. But it won't be a particularly sensitive great power. It will be rather arrogant. It was always thus with great powers.

Sid Myer: We've got a little time for some questions now and with that fabulous history lesson and then brought into the contemporary world left us with where we are right now. Could I ask the questions? One here.

Question: Ross, you mentioned the productivity gains in the labour talks in China and the union you mentioned, the fact that they don't really price capital effectively. How confident are you that China will achieve market force type capital or price capital ... particularly given its investment in Australia which is a market economy.

Ross Garnaut: The question is how confident am I that China, which now doesn't price capital in a particularly disciplined way, will come to price capital in a way that's disciplined by markets? Well, I'm not confident. That's one of the things we'll have to wait and see.

China was headed in that direction. There has been a very considerable sharpening up of practices within the banks, much greater responsibility on the banks for their own performance, for their own bad loans.

The private sector has been the most rapidly growing part of the economy since the Asian financial crisis. The path that China was on was one of liberalising and opening the whole banking system

which, of course, is the source of a very high proportion of the capital going to the large Chinese enterprises.

That's been set back by the global financial crisis. Almost on the eve of the crisis each of the big Chinese state banks took in equity from the big Wall Street and London institutions that are now either non-existent or enjoying a brief profits boom on the back of the United States Government largesse.

So that discredited what were going to be the agents of change in China. China was a bit lucky. If the crisis had come a bit – a couple of years later, we might have found a lot of Wall Street practices in the Chinese banks.

What we want is competitive practices, disciplined practices and not pre-crisis practices. So China was lucky to have brought in the foreigners into their banks too late to have absorbed a lot of that vulnerability.

But I am concerned that the crisis has left them with too much caution, including caution about market processes. We'll have to wait and see but the crisis is a setback for the development of a market oriented financial system.

Question: I've got one. I usually hold back but if no one has thought of it; I'm desperate to ask it. Ross, this is a really big change you've painted for us as a nation. It's a really big change that you've painted for us as a nation psychologically. Do you think we have the government policies and practices in place to prepare for this Asian century. Do you think we're on track or not.

Ross Garnaut: Well, we're in a better place than we might have been, partly because of Asialink. But we've got a long way to go. In Australia and the Northeast Asian Ascendancy in 1989, I put a lot of attention on education of a new generation of Australians to what I called confident familiarity with their Asian environment.

Well, this generation is better than any earlier generation of Australians. But it's a small proportion of people which work in confident familiarity in an Asian environment.

I've talked about China but it's clear from what I've said that there are similar issues in relation to India. India is doing very well. India is a couple of decades behind China but there's a very strong momentum in Indian growth.

Indonesia has come through this crisis very well. It has a functioning democracy--a tremendous achievement-- and it's now making an economy work with a functioning democracy. It's showing growth. Indonesia is on its way to being a very large economy.

So we've got a lot of learning to do about a lot of places, not just China. We've started on a journey but there's a very long way to go.

Question: Ross, thank you. Thinking about the economic rise of the power, I wonder about your observations in relation to the evolution of social policy and the social revolution of China, given the sheer enormity of the population. In parallel with this economic rise, I'm just interested in your observations of it. I mean, say for the social evolution as a corollary to the economic rise.

Ross Garnaut: There is a social transformation and then there are questions about a political transformation. The social transformation is well underway. With a couple of colleagues from ANU, I was invited by the State Council to China when China first embarked on reform in the late seventies, to be briefed in detail on the coming reforms.

China in the late 1970s was an extraordinarily closed and fettered society. It was years, it was well into my time as Ambassador 1985-8, before any Chinese would invite you to their homes. There was almost no communication between almost all Chinese families and people abroad.

There was very little communication across China. Well, that world has been transformed and it's a social transformation. There's been the sort of modernisation of Chinese society that you would expect to be associated with the economic growth that we've had—the transformation that normally accompanies economic growth.

There hasn't been a similar transformation of the political system. It is certainly a more open system, much more open than in even the early eighties, let alone Maoist times. But no, there hasn't been change in the Leninist high command, in the basic structures.

We would think from the experience of modernisation, rising incomes, rising education in the West that this is not a sustainable situation. A lot of Chinese leaders and others think about these issues.

A lot of Chinese, including leaders, are aware that there's an issue in the absence of political evolution alongside the economic transformation, but there's nowhere near an understanding of how an evolution of the political system might occur. I think that what I still think is an inevitable transformation of the political system alongside economic development can go smoothly and in an evolutionary way or through dislocation.

We've got lots of different models in the West and most of them aren't very good. Democratisation of the United States took an awful civil war. The democratisation of Germany, Japan, of much of Europe, was burdened by trauma.

Thoughtful Chinese, are aware of all of that history. They're aware of the British history which is the great transformation that happened smoothly. It's not as if the British elites of the 19th century liked democracy.

It was two great leaders, Gladstone and Disraeli, leading the competing parties who realised at different times that steps had to be made to avoid a French revolution or dislocation of society. They were wise enough and timely enough and the competition between them helped the political evolution to proceed smoothly.

That's one of the ways China might go. But it's not inevitable. How the Chinese political transformation will occur is one of the intriguing questions of our time.