
Why China Will Not Become the Dominant Power in Asia

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The belief that China will soon become the dominant power in Asia is based on assumptions that its continued and rapid economic rise, and its emergence as a regional peer of America's in military terms is all but assured. Such a belief underpins arguments that a fundamental strategic reorganisation of Asia is inevitable, and that it will be necessary and perhaps even desirable to concede to China significant 'strategic space'. Dependent largely on linear extrapolations about the future, such arguments ignore the implications of China's economic, social and national fragilities, its lack of major friends or allies in the region as well as the considerable military deficiencies and challenges faced by the People's Liberation Army. With the Defence White Paper due for release in 2015, the government should bear in mind that planning for an era of Chinese dominance in the region—or even its emergence as an American strategic peer in Asia—would be premature if not improbable. Australia should not design its defence force for war with China, but it should be able to counter Chinese coercion and contribute to Allied military operations if necessary.

In his seminal work *The Rise and Fall of the Great Powers*, Paul Kennedy states there is a very clear connection in the long run between an individual Great Power's economic rise and fall and its growth and decline as an important military power.¹ He makes two further related points: first, the power position of the leading nations has closely paralleled their relative economic position and, second, it is not certain whether the existence of 'rising' and 'falling' powers in an anarchical world order must always lead to war.² Applying these important judgments to Australia's defence and foreign policies regarding the rise of China has led to strongly opposing views. There are those who consider that the inevitable rise of China must result in that country becoming the naturally dominant power to which the United States must concede strategic space and acknowledge China's 'legitimate strategic interests'. There are others—including the authors—who believe that China's endless rapid rise economically is far from inevitable and perhaps even unlikely and that its military power will continue to lag seriously behind that of America.

The argument that China will emerge as Asia's pre-eminent power is based on assumptions that its economic and military capacities are expanding and improving at such a rate that regional dominance is all but assured.³ Yet,

¹ Paul Kennedy, *The Rise and Fall of the Great Powers* (London: Unwin Hyman, 1987), p. xxii.

² *Ibid.*, pp. xxiv, 537.

³ For example, see Martin Jacques, *When China Rules the World: The End of a Western World and the Birth of a New Global Order*, 2nd edition (London: Penguin Books, 2012).

the sustainability of China's rapid economic rise and capacity to embark on the path towards becoming an advanced and resilient political-economy, in addition to its ability to become a genuine military superpower wielding proportionate regional influence, is widely assumed but rarely analysed in any depth, at least in the Australian literature. In examining the factors that go towards the development of Chinese national power—and its ability to use it to achieve national objectives—predictions about a Chinese superpower with the ability to dominate Asia would be premature, if not improbable, in our view.

The Limitations of China's 'Economic Miracle'

When a book by Harvard University's Ezra Vogel entitled *Japan as Number One*⁴ became a bestseller in 1980, the Japanese economy had been growing continuously at around 10 per cent per annum for two decades since 1960. Some fifteen years later and with Japan well into its lost decade of zero or negligible economic growth, Paul Krugman penned a seminal article entitled 'The Myth of Asia's Miracle'.⁵ In the article, Krugman offered the simple but irrefutable economic argument that "Economic growth based on expansion of inputs, rather than on growth in output per unit of input, is inevitably subject to diminishing returns."⁶ Observing that this was true of the Soviet Union, Krugman applied the same economic logic to explain the problems faced by Japan from the 1980s onwards. The observation was not so much that growth in these inefficient economies had been illusory but that rapid growth based on ever more finite reserves of capital and labour inputs becomes more and more inefficient, and is therefore ultimately unsustainable.

As any economist would confirm, there are only three ways to generate economic growth: adding more capital inputs, more labour inputs, or using capital and/or labour more productively. In essence, Krugman was simply reaffirming the reality that although countries have different approaches in terms of emphases on the drivers of growth, the laws of economics as described above apply universally to all political-economies.

Is China simply doubling down on recent Japanese mistakes? This comes down to how China has achieved growth, especially since the mid-1990s. Most commentators focus on the spectacular success of China's export sector and the emergence of China as the 'world's factory'. The export-manufacturing sector is indeed significant and a vibrant component of the economy, employing possibly fifty million people directly, and another one hundred million people indirectly. But the greater contributor to Chinese growth is domestically funded fixed-investment which was behind around 40

⁴ Ezra Vogel, *Japan as Number One: Lessons for America* (Mass: Harvard University Press, 1979).

⁵ Paul Krugman, 'The Myth of Asia's Miracle', *Foreign Affairs*, vol. 73, no. 6 (1994), pp. 62-71.

⁶ *Ibid.*, p. 63.

per cent of growth throughout the late-1990s and the previous decade. In 2009, and due to the massive stimulus ordered by the government, more than 70 per cent of growth was the result of fixed investment.⁷

To put China's reliance on fixed investment in context, during the periods of rapid industrialisation in Japan, South Korea and Taiwan in the 1950s and 1960s, fixed investment as a proportion of GDP was at around 30 per cent or below; and only for brief periods of several months did levels touch 35 per cent.⁸ In contrast, Chinese fixed investment as a proportion of GDP jumped from a more sustainable 35 per cent in the 1980s, to 38 per cent in 1999, and to 45 per cent in 2004.

According to official World Bank data, which is generally considered to be conservative in its estimate, the figure is now 49 per cent of GDP, the highest in the world with the exception of highly distorted economies of Equatorial Guinea, Mongolia and Bhutan. To explain these extraordinary numbers in another way, it is estimated that over the previous decade, China's official GDP has increased by 162 per cent. Of this 162 per cent increase, additional labour inputs have contributed about 6 per cent. But an enormous 135 per cent can be attributed to fixed investment. This means that total factor productivity (TFP)—using capital and/or labour more productively—contributed only 20 per cent out of the 162 per cent GDP increase. In other words, increasing levels of fixed investment has been behind more than 80 per cent of China's GDP growth over the past decade.⁹

Even if these figures deviate slightly from the truly accurate one (which is unattainable given the unreliable nature of China's official statistics), one can say with confidence that Chinese reliance on the levels of fixed investment to drive and sustain growth is unprecedented in economic history. It is therefore unsurprising that the Chinese economy's deployment of capital which is used to fund fixed investment is now widely viewed as unsustainable.

The evidence for this is ample. For example, the amount of capital input needed to produce one additional dollar of output (i.e., capital-output ratio) increased from 2:1 in the 1980s to about 4:1 in the 1990s, and was well over 5:1 in 2011 according to OECD figures.¹⁰ The capital-output ratio estimate for 2012 was 5.5:1 meaning that a capital input of \$5.50 achieves only \$1.00

⁷ See Ashvin Ahuja and Malhar Nabar, 'Investment-Led Growth in China: Global Spillovers', *IMF Working Paper WP/12/267*, International Monetary Fund, November 2012.

⁸ For historical comparisons of the role of fixed investment between the East Asian economies, see John Lee, 'The False Promise of "Market Socialism" in China', *Policy*, vol. 23, no. 3 (2007), pp. 23-9; 'China Can't Beat Economic Laws', *The Australian*, 20 August 2013.

⁹ See Erik Britton, 'Consumption: New Key to Chinese Growth', *China Business Review*, 1 July 2010.

¹⁰ OECD, *Economic Outlook for Southeast, China and India 2014* (Paris: OECD Publishing, 2014).

in additional output.¹¹ As economic logic insists, and the development experiences of other East Asian countries show, capital-output ratios at this level depict an enormously wasteful and capital-inefficient economy that is not sustainable.¹²

Undertaking such an unprecedented capital-intensive model of growth has other deleterious ramifications. Of particular concern is that the enormous level of capital inputs used to generate growth has meant that national corporate debt levels have risen from 147 per cent of GDP at the end of 2008 to over 250 per cent at the end of June, 2014.¹³ To put this in some context, the expansion of debt—which has been used to finance capital inputs—from US\$9-10 trillion in 2008 to US\$20-25 trillion in 2014 exceeds the size of the total American commercial banking system.¹⁴

Such an unprecedented increase in debt-financed capital has also created systemic problems for the entire financial system in China. In 2011, an investigation by the Chinese Academy of Social Sciences put the debt to asset ratio of Chinese firms at 105 per cent, the highest amongst the twenty major economies studied.¹⁵ That China's overall debt to GDP ratio was then 169 per cent and is now over 250 per cent some three years later means that corporate debt is now undoubtedly far higher than it was in 2011. Given that so much of the fixed investment is wasteful which is reflected in the rapidly rising capital-output ratios, there is almost universal agreement that the official non-performing loan (NPL) ratio of 1 per cent—which has not changed for a decade—is not credible. Instead, most independent analyses conservatively place the NPL figure to be at least 5 per cent, meaning the NPLs on the balance sheets of state-owned banks—whose liabilities are ultimately government liabilities—could be around US\$2 trillion.¹⁶

This brings us back to Krugman's warning about growth models based predominately on ever-increasing levels of capital investment: they eventually run out of steam and no economy has ever escaped the so-called 'middle-income' trap through ever increasing capital (or labour inputs). With an export sector no longer capable of driving rapid Chinese GDP growth as it did in the 1990s and earlier this century, all medium-term indicators point to a consensus that the ability of fixed investment to pick up the slack is

¹¹ See John Mauldin, 'China's Minsky Moment?', *Forbes*, 22 March 2014.

¹² See David Dollar, 'China's Rebalancing: Lessons from East Asian Economic History', *John L. Thornton China Center Working Paper Series* (Washington DC: The Brookings Institution, October 2013).

¹³ See Jamil Anderlini, 'China Debt Tops 250% of National Incomes', *Financial Times*, 21 July 2014.

¹⁴ See Satyajit Das, 'China's Debt Vulnerability', *EconoMonitor*, 9 April 2014.

¹⁵ See 'Corporate Debt Reaches "Alarming" Levels', *China Daily*, 18 May 2012.

¹⁶ See Dexter Roberts, 'China Bad Debt Could Spark Global Growth Slump', *Business Week*, 9 May 2014.

nearing its end. This means the rapid growth rates of the 1990s and the previous decade are no longer possible.¹⁷

Even if the current Fifth Generation of Leaders manage to successfully transition their economy from one led by investment and exports to one driven by domestic consumption, such a transition would involve severe short- and medium-term disruptions to the economy with precarious risks for the regime. Additionally, such a transition would mean the winding back of the privileged access to capital and opportunity afforded to state-owned-enterprises in favour of a currently suppressed private sector—undermining the primary strategy used by the Chinese Communist Party (CCP) to ensure its continued relevance in the country's rapidly industrialising economy. Besides, even if reforms were successfully undertaken and domestic consumption were to become the primary driver of growth, GDP growth rates would still slow significantly from the recent past as it is almost impossible, and indeed unprecedented, for consumer-driven economies to grow at the rapid rates enjoyed by China over the past few decades.

Bear in mind that approaches based on linear extrapolations of Chinese absolute economic size expressed in a GDP figure to inform sensible assumptions about Chinese power are also superficial—as it was with Japan, a country with a far more resilient political-economy, in the 1980s. In isolation, GDP size and growth rates offer no decisive indication of how a country is actually faring. Remember that the Soviet Union officially tripled in size from 1950 to 1973, yet its economic model was fundamentally flawed as we realised in hindsight. GDP is essentially an accountant's tool used to document final economic activity within a country in any given year. But GDP does not measure whether economic activity is productive, profitable or even commercially irrational.

Indeed, the self-criticism previously offered by then Chinese Premier Wen Jiabao that the country's economic model is “unstable, unbalanced, uncoordinated and unsustainable”¹⁸ is offered on the basis that much of the fixed investment activity is unproductive, not needed or significantly under-utilised, and cannot be justified by any commercial logic. Even so, activity such as the building of uninhabited housing or an increase in steel-making capacity which will not be utilised is counted as ‘economic growth’ under measurements of GDP and is erroneously treated by many outside commentators as if such activity contributes positively to the accumulation of China's national strength.

¹⁷ For example, see World Bank, *China 2030: Building a Modern, Harmonious, and Creative Society* (Washington DC: World Bank, 2013).

¹⁸ See Josephine Lau and Yanping Li, ‘China's Growth Is Unstable, Unsustainable, Wen Says’, *Bloomberg*, 16 March 2007.

In reality and as the next section argues, how a country generates growth matters. An economy driven by mandated growth targets rather than commercial logic and/or merit, and artificially dominated by a relatively small number of highly protected and privileged State-Owned Enterprises (SOEs), leaves the country ill-equipped to deal with many of its domestic challenges. These challenges are far more intractable and serious than is generally recognised in the Australian discussion about Chinese power and its future place in Asia. Nowhere is this more apparent than in the country's lack of structural and policy preparedness *vis-à-vis* the inevitable aging of its society—an approaching challenge which could become the most significant millstone around the neck of the country's leaders over the next two decades.

China Growing Old Before it Becomes Rich

Although Japan is often considered the 'grandfather' of East Asia, much more attention should be paid to China when it comes to estimating the future power balance in the region. Currently, China has a population of about 1.35 billion people, but this number is expected to shrink slowly by around 2030.

More important is the ratio of working-age people to those over sixty-five, the latter considered aging or formal retirees. In the 1980s, the proportion of the working-age population (fifteen to sixty-four years) was more than 73 per cent of the overall population. Currently at about 68 per cent, the working-age population is expected to decline to about 65 per cent in 2020, and 60 per cent in 2035. In 2015, it is expected that the absolute size of the labour force will begin to shrink as more people leave than enter the workforce.¹⁹

The significance of these numbers become apparent when one compares the proportion of working-age people with formal retirees. When China embarked on reforms in 1979, there were about seven working-age persons to every retirement-age one. Today, the ratio is about 5.5 to 1. Current projections suggest that by 2035 there will be barely more than two working persons for every retiree. In other words, the old-age dependency ratio will be more than double over the next two decades.²⁰

The age profile of the working population also matters. Studies show clearly that most workers are at their most productive and innovative from their late twenties to their mid-forties.²¹ This has been the basis for China's 'demographic dividend', the massive productivity generated by the combination of declining fertility levels and a mass of young workers entering

¹⁹ See World Bank, *China 2030*, p. 8.

²⁰ *Ibid.*

²¹ For example, see Vegard Skirbekk, 'Age and Individual Productivity: A Literature Survey', *MPIDR Working Paper 2003-028* (Rostock, Germany: Max Planck Institute for Demographic Research, August 2003); 'Age Shall Weary Them', *The Economist*, 11 May 2013.

the workforce with relatively light familial responsibilities or burdens.²² In fact, one study estimates that the effects of a favourable working-age population alone accounted for between 15-25 per cent of per capita GDP growth in China from 1980-2010, and that this advantage is all but exhausted.²³

Yet, while there are currently around 120 million Chinese people sixty-five years or older, by 2035, there will be around 320 million with the overall population only about one hundred million larger than it is today. Even within the working population, in 2035 there will be 1.5 older workers (fifty to sixty-four years) for each of their younger counterparts (fifteen to twenty-nine years old), which is the direct opposite of the current situation.

Moreover, for a number of reasons it is extremely unlikely that these trends can be arrested or reversed. For a start, China's aging population is largely the result of a dramatic increase in average lifespan, which has increased from under sixty-five years in 1980 to the current seventy-five years. Fertility rates have also declined, from 2.63 children per woman in 1980 to about 1.5 in 2011. Wealthier cities such as Shanghai which has a reported fertility rate of only 0.6, the lowest of any major city in the world, provide evidence that emerging Chinese middle classes, like Western counterparts, are choosing lifestyle and career opportunities over larger families. While actual future figures could vary slightly from the trend lines, little can be done about China's aging demographics over the next few decades. Even if the one-child policy were to be relaxed or abolished, the aging trend would not be reversed to any appreciable degree for several decades.

By 2030, China's age demographics will resemble that of Norway or the Netherlands today. (Incidentally, the United States is the only great power with favourable age demographics leading up to the middle of this century.) But in assessing national preparedness to meet the aging challenge, it is almost certain that unlike aging advanced economies, China will be the first major economy in history to *grow old before it grows rich* (or even moderately rich). This should cause us to look at more than China's GDP size and growth, which although impressive, has nevertheless been underpinned by a political-economic model that has left the country woefully unprepared for its inevitable aging for a number of reasons.

First, China's state-dominated political-economy means that the best economic opportunities are reserved for the approximately 140,000 SOEs. Likewise, around three-quarters of formal finance (mainly bank loans) are given to the SOEs rather than the millions of private firms, meaning that

²² Demographer David Bloom, who coined the phrase 'demographic dividend' has argued that around one third of economic growth in East Asia from 1960-90 has been the direct result of favourable demographics. See David E. Bloom, '7 Billion and Counting', *Science*, vol. 333, no. 6042 (July 2011), pp. 562-9.

²³ Feng Wang, 'Racing Towards the Precipice', *China Economic Quarterly*, June 2012.

SOEs dominate investment in every major sector of the economy except for export-manufacturing.²⁴ The consequence of such a structure is that the revenues of SOEs have been rising at rates far exceeding GDP growth, while household and disposable income has been rising at rates significantly below GDP growth.

The suppression of household and economic opportunity in favour of SOEs is reflected in World Bank Development Indicators data showing that while investment and household consumption growth was rising at similar rates in the first fifteen years of reform (1979-94), investment growth has consistently and significantly exceeded household consumption since the late 1990s²⁵—a period when the CCP decided that SOEs were to reassert dominance in all 'strategic' and 'important' sectors of the Chinese economy through privileged and cheap access to capital, subsidy regimes, and through other regulatory and tax concessions.²⁶

The point is that the state-owned sector rather than private households have been the primary beneficiaries of economic growth and development over the past fifteen years, a reversal of what occurred from 1979-1989 when households took the lead in economic activity.²⁷ It is therefore not surprising that household consumption as a proportion of GDP in China is around 33 per cent, by far the lowest of any major economy in the world. In a country where up to four hundred million people still live on less than US\$2 per day, according to World Bank estimates, the national bias towards the state corporate sector rather than households leaves a poor society tragically unprepared for its own aging.

Second, a GDP per capita figure (derived from dividing national output by the number of people) offers little indication of how wealth is actually distributed throughout the country. When considering measurements of income distribution such as the Gini coefficient (where zero denotes perfect equality and one denotes perfect inequality), China has gone from being the most equal society in all of Asia to the least equal within a generation. Its Gini coefficient has risen from 0.25 in the 1980s to 0.38 in the 1990s, to around 0.5 currently. As a comparison, the World Bank figures for India, the United States, Japan and Russia are 0.34, 0.43, 0.38 and 0.42 respectively.

²⁴ See John Lee, 'China's Corporate Leninism', *The American Interest*, May/June 2012, pp. 36-45.

²⁵ See Australian Treasury, 'The Familiar Pattern of Chinese Consumption Growth', *Economic Roundup*, Issue 4, 2012.

²⁶ For a summary of Chinese policies designed to entrench State-Owned Enterprise dominance in key sectors, see Derek Scissors, 'Chinese State-Owned Enterprises and the US Policy on China', *Testimony for the U.S.-China Economic and Security Review Commission*, 12 February 2012.

²⁷ For the differences between economic models from 1979-1989 compared to the mid-1990s onwards, see Yasheng Huang, *Capitalism with Chinese Characteristics* (New York: Cambridge University Press, 2008).

Moreover, the link between suppressed household income on the one hand and dangerous levels of income inequality, on the other, is unmistakable. In a system where around 140,000 SOEs receive the lion's share of economic opportunity and capital at the expense of millions of private firms and tens of millions of informal businesses, a small number of well-connected and well-placed 'insiders'—generally those with political connections or ties with the CCP or SOEs—benefit disproportionately from the current growth model.²⁸ Revealingly, and from 1979-1989 when household and private initiative drove economic growth, China's Gini coefficient was stable at around 0.3. It was only after the mid-1990s with the re-emergence of the state-led model that inequality increased dramatically.²⁹

The point about inequality of income and national wealth is that China's suppressed household sector will exacerbate the country's unpreparedness for an aging population since many retirees will be in a far worse and more vulnerable financial position than they otherwise could be. This unpreparedness is further exacerbated by the reality that only around one third of all urban residents and less than 5 per cent of rural residents have some form of central, provincial or local pension fund.³⁰ Although the current pension scheme covers a minority of citizens, the consensus amongst researchers is that the state's pension liability amounted to about US\$2.9 trillion in 2013.³¹ Other reports estimate that the state's pension liability could amount to US\$10.8 trillion over the next two decades (or almost 40 per cent of GDP based on a generous assumption of 6 per cent GDP growth each year).³² As the following section will argue, such domestic vulnerabilities and shortcomings will have a profound impact on the development of Chinese national power which is poorly appreciated in the Australian discussion.

National Frailty and Domestic Fragility

Many countries have made the transition from very-low income to middle-income status (approximately US\$15,000 per capita), and China at less than US\$10,000 per capita still faces obstacles to get there. But only around

²⁸ See Minxin Pei, *China's Trapped Transition: The Limits of Developmental Autocracy* (Cambridge, MA: Harvard University Press, 2008); John Lee, *Will China Fail?*, 2nd edn (Sydney: CIS, 2009).

²⁹ For a comparison and analysis of inequality in China during the reform period since 1979, see John Knight, 'Inequality in China: An Overview', *World Bank Research Observer*, vol. 29, no. 1 (2014), pp. 1-19; Jacek Kochanowicz, Joanna Rymaszewska and Joanna Tyrowicz, 'Intra-Provincial Inequalities and Economic Growth in China', *Working Papers No. 10/2008* (Warsaw: University of Warsaw, Faculty of Economic Sciences, 2008).

³⁰ China's National Bureau of Statistics figures for 2010. See also Robert C. Pozen, 'Tackling the Chinese Pension System', *Paulson Policy Memorandum*, July 2013.

³¹ See 'Pension Gap to Hit \$2.87 Trillion', *China Daily*, 14 June 2012.

³² For example, see reports by Aileen Wang and Koh Gui Qing, 'Analysis—China Slides Faster into Pensions Black Hole', *Reuters*, 30 September 2012; 'China Pension Shortfall to Be CNY18.3 Trl in 2013: Report', *Caijing*, 14 June 2012.

thirty countries have made the jump from middle-income to high-income status. Except for a small number of oil-rich Middle Eastern states, those economies that have achieved this all have the same characteristics that do not apply to contemporary China. These include institutions required for sophisticated commercial interactions such as rule-of-law, strong property and intellectual property rights regimes that are reliably enforced, and an independent judiciary needed to fairly and reliably resolve commercial disputes between commercial actors. Unlike modern-day China, advanced and innovative economies also have political-economies that largely allocate economic opportunity and credit based on commercial merit rather than on policy or political grounds. In contrast, it is not economically feasible to achieve sustainable growth, let alone become a high-income advanced economy, by adding ever increasing levels of capital and labour inputs.

In addition to these serious flaws in the overall political-economic model that will invariably entail a structural slowdown, reform and domestic concerns will increasingly increase the burdens on the public purse. Currently, the CCP devotes a large share of government finances to enhancing Chinese national power and influence through double-digit increases for its military, the People's Liberation Army (PLA), and its paramilitary, the People's Armed Police (PAP). For example, in the 2014 budget, US\$241.5 billion was officially spent on the PLA and PAP or 11.4 per cent of the total budget. If the true figure for military spending as estimated by organisations such as the Stockholm International Peace Research Institute is used, the proportion of the budget spent on defence and national security is 14.6 per cent (8.8 per cent on the PLA and 5.8 per cent on the PAP).³³

To mitigate what demographer Nicholas Eberstadt has called China's "slow-motion humanitarian tragedy",³⁴ there will need to be a much larger share of the budget allocated to public goods such as social security and unemployment benefits, and healthcare which constitutes 10.5 per cent and 6.1 per cent of the 2014 budget respectively.³⁵ This is in addition to enormous and mounting burdens on the public purse such as existing pension liabilities and NPLs hidden in the books of state-owned banks, both mentioned earlier.

Additionally, there will need to be a massive transfer of national wealth and opportunity from SOEs to private businesses and households in order for those without adequate pensions—the majority of the people—to dramatically raise their incomes and look after themselves and their families

³³ Figures from China's Ministry of Finance and SIPRI. For a summary of the make-up of China's 2014 fiscal budget, see Charles Riley, 'Inside China's \$2.2 Trillion Budget', *CNN Money*, 15 January 2014.

³⁴ Nicholas Eberstadt, 'China's One-Child Mistake', *Wall Street Journal*, 17 September 2007. See also Nicholas Eberstadt, 'The Demographic Future: What Population Growth—and Decline—Means for the Global Economy', *Foreign Affairs*, vol. 89, no. 6 (2010), pp. 54-65.

³⁵ China's Ministry of Finance figures.

as they age. The financial role of the state in managing the aging demographic will be exaggerated by the unique phenomenon wrought by the legacy of China's one-child policy known as the 4-2-1 problem: in a large number of cases, four grandparents and two parents will be looked after by one child. All this will necessitate dramatic and possibly destabilising change to the Chinese political-economy. Such reforms will also erode the dominant role SOEs currently play in all key sectors of the economy, and subsequently the capacity of the CCP to selectively use SOEs to advance state power and objectives.

Finally, it must be noted that the legitimacy of the CCP depends first and foremost on improving the living standards of its citizens. This means that while developing a powerful military and pursuing an expansive foreign policy may well reinforce national pride, the regime cannot simply do so at the expense of ignoring pressing domestic problems and frailties that are worsening in important respects. Although the regime has so far survived, officially reported instances of mass unrest have grown to above 180,000 according to 2011 figures, rising from just a few thousand in the mid-1990s³⁶—proof that rapid growth has worsened rather than tempered national instability. With a slowing economy, and with structural economic and social deficits becoming worse rather than better, China is a large but fragile power ruled by a vulnerable Party which cannot afford any major economic or foreign policy disasters. These do not appear to be strong foundations for the emergence of the dominant state in Asia—an argument reinforced by the following examination of China's strategic isolation and military inadequacies that will be difficult to rectify in the foreseeable future.

China as the Lonely Asian Rising Power

China has very few powerful or influential friends in Asia. For a country with such a large population and the world's second largest economy it does not have many close bilateral relationships. In her book, *China: Fragile Superpower*, Susan Shirk describes China as strong abroad but fragile at home. This strikes us as being incorrect: in our view, China is certainly fragile domestically but it is also a lonely power when it comes to acquiring real influence in Asia. A listing of China's friendships in the region reveals that only North Korea and Pakistan can be counted as countries with which it has a strong relationship. But what sort of trust can Beijing have in Pyongyang not dragging it into an unwanted war with South Korea? As for Pakistan, it is constantly teetering on the edge of becoming a failed state and risks a conflict with India that certainly would not be in China's interests.

³⁶ See Christian Gobel and Lynette H. Ong, *Social Unrest In China* (London: Europe China Research and Advice Network, 2012).

For centuries in the past, Imperial China was feared and respected as the dominant power in Asia, as Susan Shirk has correctly observed.³⁷ But that was all a very long time ago when China faced no real competition until the arrival of European colonial powers in the nineteenth century. China now operates in a highly competitive regional environment against such major powers as the United States, Japan and India. Of late, many Southeast Asian countries have become increasingly concerned about China's assertiveness and several of them have taken steps to align themselves closer to the United States. Not even Russia can be counted by Beijing as a long-term friend, let alone an enduring ally.

The following sections examine in turn China's strategic situation in Northeast Asia, Southeast Asia and South Asia. We focus on geopolitical relationships that may threaten or undermine China's influence and capacity to wield power in Asia.

Northeast Asia is a critical area of geopolitical confrontation for China. In this neighbourhood, it faces the risks of war on the Korean Peninsula, a well-armed Japan that increasingly identifies China as a threat, and a United States that has strong forces based in both Japan and South Korea. China's relations with Japan in particular are now tense and there is a growing risk of miscalculation and perhaps even military conflict. Tokyo is building up its naval and air assets in response to what it perceives as territorial aggressiveness by Beijing. Japan is strengthening its military relations with both the United States and Australia and assisting countries such as Vietnam and the Philippines to resist China's territorial claims in the South China Sea. While it is true that China is developing comprehensive military capabilities to deny the United States unchallenged military operations in its maritime approaches, Japan and the United States have the capacity to deny China freedom of movement in the East China Sea and effectively blockade its naval forces from breaking out into the deep ocean. The Shinzo Abe Government has reinterpreted the Japanese Constitution to exercise collective self-defence, which will be permissible when there is a danger of a country such as the United States that has a close relationship with Japan coming under armed attack. Although clear limitations will remain on the use of force by Japan, it is obvious that China's threatened use of force is causing Tokyo to strengthen considerably its military situation. In the worst case, and if Japan loses confidence in the US alliance, this may eventually provoke Japan to consider taking the nuclear weapons option it has long denied itself. That would certainly not be in China's strategic interests.

Some commentators believe that Washington must concede strategic space and acknowledge "legitimate strategic interests" to a China that will become the naturally dominant power in the region.³⁸ This is a highly contested

³⁷ Susan L. Shirk, *China Fragile Superpower* (New York: Oxford University Press, 2007), p. 111.

³⁸ Hugh White, *The China Choice* (Melbourne: Black Inc., 2012).

proposition that asserts the United States and its allies must accommodate China as a power-sharing equal as the only rational response to its rise to power. That is a proposition which we reject because, as argued throughout this article, we do not accept that China is an endlessly rising power that has no serious domestic and external constraints. Neither do we accept that America is a power in terminal decline. Rather, we are of the view that the United States will remain the world's dominant military power for the foreseeable future. Of course, it will be important that Washington demonstrates to China that it will not accept Chinese use of military force towards America's allies and friends in Asia.

On the Korean Peninsula, China is trying to have the best of both worlds strategically but that is an unworkable proposition. Beijing's current gamble is that it can retain North Korea as an ally that, if necessary, will go to war to prevent a unified Korea that is an ally of the United States. But, at the same time, Beijing is trying to develop close relationships with Seoul and playing on the Republic of Korea's (ROK) enmity towards Japan. In the end, China will find that if it cannot restrain Pyongyang's dangerous unpredictability, the ROK will have no option but to continue to rely upon the threat of US retaliation against North Korean aggression.

China and Russia are currently embarking upon a new phase in their relationship that is centred on their resistance to what they see as unfettered American power dominating the current international order. Both China and Russia are leagued together in their suspicions of the United States and the West generally. They share in common a distrust of Western invented international norms and rules of behaviour. Russia and China have become more assertive recently. China is using coercion backed up by the implicit threat of military force in the East China Sea against Japan over the Senkaku/Daiyou Islands and in the South China Sea against Vietnam and the Philippines. For the foreseeable future these two large authoritarian countries are threatening to destabilise the international system. Russia needs its alignment with China and China needs Russian energy and resources. But the rapidly growing inequality in power between China and Russia and their long common border—let alone their huge ethnic and cultural differences—does not auger well for a future peaceful relationship.

Southeast Asia is a region that China traditionally has seen as a sphere of influence as evidenced by its 1,000 years of suzerainty over Vietnam, its ethnic influence in Thailand, the presence of over 25 million overseas Chinese in Southeast Asia and its attempts in the 1960s and 1970s to proselytise communism in the region. Today, China is the major trading partner of most Southeast Asian countries. The region developed ASEAN as a loose-knit multilateral community in the wake of the Vietnam War in an attempt to avoid being dominated by the major powers. It is now a community of ten countries and over 600 million people and it has devised the ASEAN way of making decisions by consensus and avoiding

provocation. Lately, however, it has found itself being pushed around by an increasingly assertive China. Beijing has demonstrated its imperial haughtiness by reminding ASEAN members that they are small countries and China is a big country. Thus, it will not consent to negotiating with ASEAN as a group over the South China Sea so that it can pick-off small regional countries one by one. As a result of this overbearing Chinese pressure, several countries in the region have moved towards closer relationships with America.

Geopolitically, Southeast Asia looms as a crucial chokepoint through which China's huge imports of energy and resources must be transported by sea. According to the Pentagon, approximately 84 per cent of China's oil imports now transit through the Strait of Malacca and the South China Sea.³⁹ China's international trade (exports plus imports) accounts for almost 50 per cent of its GDP and is a highly significant component in its quickly rising living standards. But international trade also imposes great vulnerabilities on China: war with the United States would see China at catastrophic risk of its sea lines of communication through Southeast Asia being blockaded. President Hu Jintao identified this as being China's Malacca dilemma, where Chinese oil imports traverse vulnerable waterways.⁴⁰

In South Asia, China does not have close relations with India and instead it has developed relationships with countries on India's periphery—Pakistan, Bangladesh and Sri Lanka. However, India is by far the dominant power on the sub-continent. Kissinger argues that India will be a fulcrum of future regional order based on its geography, economic potential and tradition of sophisticated leadership.⁴¹ India aspires to be accepted as a great power and China is seen as its arch rival.⁴² These two great Asian powers could not be more unlike: India is the world's largest democracy whereas China is an authoritarian communist country; India is set to outstrip China in population size and, unlike China, its demographic base is young with all this implies for India's future economic growth. These two powers have long-standing border disagreements along the Himalayas. And as China extends its naval power into the Indian Ocean this will challenge what New Delhi sees as its natural strategic primacy in the ocean named after it. China and India are two nuclear powers with very different histories and cultures. China's increasing military build-up is causing India to respond, including by cautiously developing its relationships with America as well as an eastward looking policy towards ASEAN. As Harris notes, the relationship between

³⁹ Office of the Secretary of Defense, *Annual Report to Congress: Military and Security Developments Involving the People's Republic of China 2014*, Department of Defense, Washington DC, 24 April 2014, p. 18.

⁴⁰ Timothy Beardson, *Stumbling Giant: The Threats to China's Future* (New Haven: Yale University Press, 2013), p. 385.

⁴¹ Henry Kissinger, *World Order* (London: Allen Lane, 2014), p. 208.

⁴² For a fuller analysis of China's relationships with India see Stuart Harris, *China's Foreign Policy* (Cambridge: Polity Press, 2014) pp. 158-62.

China and India lacks warmth and depth and there are serious points of friction and underlying mistrust.⁴³

Overall, China's poor relationships with the United States, Japan and India do not auger well for its ability to shape the future regional order. Moreover, Beijing's increasing aggressiveness and harsh attitudes towards its pre-emptive territorial claims in the region run the risk of miscalculation and conflict. This risk, coupled with Beijing's inclination to challenge established international norms of behaviour, is a suitable point to turn to China's military build-up and an examination of its strengths and weaknesses.

Is China's Military Power Exaggerated?

China undoubtedly has developed substantial military capabilities in the last twenty years or so. America's overwhelming demonstration of superior conventional military power in the first Gulf War in 1991 was a great revelation to Beijing. Since then, it has aimed to develop technically advanced military forces capable of fighting and winning short duration, high-intensity regional contingencies.⁴⁴ The Pentagon's latest report to Congress on China's military makes it clear that preparing for potential conflict in the Taiwan Strait "remains the focus and primary driver" of China's military investment.⁴⁵ Preparing for contingencies other than Taiwan include potential contingencies in the South and East China Seas and a range of missions beyond China's coast, including sea lane security, counter piracy, peacekeeping, humanitarian assistance and disaster relief. The report concludes that China's military investments provide it with a growing ability to project power at increasingly longer ranges.

Although China has developed potent military capabilities to make it hazardous for US forces to operate in the approaches to China, the fact remains that Beijing could not enforce a full military blockade of Taiwan or attempt a full-scale amphibious invasion of that island.⁴⁶ The Pentagon also observes that limited logistical support remains a key obstacle preventing China's navy from operating more extensively beyond East Asia, particularly in the Indian Ocean.⁴⁷ In addition, "it is not clear whether China has the capability to collect accurate targeting information and pass it to launch platforms in time for successful strikes against targets at sea beyond the first island chain".⁴⁸

It is instructive that the Office of the Secretary of Defense makes such cautionary remarks. The fact of the matter is that China's forces still lag

⁴³ *Ibid.*, pp. 159, 160.

⁴⁴ Office of the Secretary of Defense, *Annual Report to Congress*, p. i.

⁴⁵ *Ibid.*

⁴⁶ *Ibid.*, pp. 54-5.

⁴⁷ *Ibid.*, p. 38.

⁴⁸ *Ibid.*, p. 32.

considerably behind those of the United States in overall resources, technology and experience. In our view, China is twenty years behind the United States in high-technology weapons and sensor development. China is not a military superpower and will not become one until it develops the capability to project decisive military power anywhere on the globe. Presently, China is a regional military power entirely without any modern combat experience and with major deficiencies in doctrine, human capital and training—and particularly the complexity and realism of joint operations. China's ability to develop a powerful military is also seriously constrained by the fact that its own technological level remains relatively low and that its only source of foreign arms is Russia.⁴⁹

The most comprehensive recent analysis available in the public domain of China's military capabilities versus those of the United States has been written by Aaron Friedberg, Professor of Politics and International Affairs at Princeton University.⁵⁰ Unlike many commentators, Friedberg is not inclined to exaggerate China's military capabilities whilst acknowledging the growing threat to the American position in East Asia. For example, he cites a survey by the US Office of Naval Intelligence describing China's capabilities in the acquisition of targeting information essential for anti-submarine warfare (ASW) as marginal.⁵¹ China's navy has begun to invest in the underwater sensors, dedicated fixed-wing aircraft, helicopters and surface vessels necessary to locate and track enemy submarines, but it has yet to address its shortcomings in ASW. This is an important deficiency given America's big advantage in terms of tracking other submarines and the difficulty all other countries have of detecting US submarines. China's conventional submarines are relatively easy to detect and its nuclear boats possess little ASW capability.⁵² Without major improvements in ASW, the Chinese Navy would be an easy target for US (and Japanese) military forces. China's military would be hard-pressed to prevent hostile submarines and unmanned underwater vehicles from operating close to its shores and destroying its surface fleet.⁵³ It also remains unclear how capable of joint coordination China's different services are in operations over water. Integrated operations between a highly regimented and rigidly structured Chinese Air Force and an immature and sea-based Navy would require technological and service-culture innovations, as well as exercises less carefully scripted than has been usual, to develop the requisite interoperability and inter-

⁴⁹ Jacques, *When China Rules the World*, p. 355.

⁵⁰ Aaron L. Friedberg, *Beyond Air-Sea Battle: The Debate over US Military Strategy in Asia* (London: International Institute for Strategic Studies, April 2014).

⁵¹ *Ibid.*, p. 29.

⁵² Benjamin Schreer, 'The Alliance Dimension of Australia's Future Submarine', in *The Submarine Choice*, ASPI Strategy Series, September 2014, p. 46; Thomas G. Mahnken, 'China's New Nuclear Fleet and the US Navy', in Andrew S. Erickson, Lyle J. Goldstein, William S. Murray and Andrew R. Wilson, *China's Future Nuclear Submarine Force* (Annapolis: Naval Institute Press, 2007), p. 379.

⁵³ Aaron Friedberg, *Beyond Air-Sea Battle*, p. 37.

service coordination.⁵⁴ In promoting officers and selecting leaders, the Chinese prize loyalty to the Communist Party and reliability over independence and initiative.⁵⁵ In the meantime, the United States is pressing ahead with technological game changers, such as unmanned undersea vehicles (UUVs) for reconnaissance, surveillance and strike that could radically change undersea warfare to China's huge strategic disadvantage.

There are similar gaping deficiencies in China's air defence capabilities against any technologically advanced enemy. As Friedberg points out, China's ability to detect and intercept ballistic missiles or stealthy aircraft and cruise missiles appears to be limited.⁵⁶ Moreover, the United States is working on technological advantages that will make China's task of air defence even harder—they include a new low observable penetrating bomber and long-range precision strike with very high-speed hypersonic glide vehicles.⁵⁷ Such developments would greatly increase the expenditure that Beijing would have to devote to both active and passive defence measures.

In addition, China's reconnaissance network remains vulnerable to attack by a sophisticated foe: over the horizon radar (OTHR) antennas are large and fragile structures that are crucial to China's ability to track and target American aircraft carriers.⁵⁸ China probably does not yet have the kind of detailed, real-time targeting information it needs to make the DF-21 anti-ship ballistic missile into an effective weapon.⁵⁹ In addition, the serious growth of China's area-denial capabilities is unlikely without sea-based aviation and land-based, over-water, mid-air refuelling capability, in addition to some means of coordination and defence (for example, an AWACS equivalent).⁶⁰ These are all vulnerable military capabilities for China to develop.

Some observers argue that China will be able to use nuclear weapons against US forces in the region with impunity because the United States dare not escalate the conflict to large-scale military action against China because of the risk to US cities.⁶¹ This seriously underestimates American war-fighting culture, its possession of a much wider range of tactical and strategic nuclear weapons than China, and the fact that China is one of the most vulnerable countries in the world in terms of its population density to nuclear attack.

⁵⁴ Andrew S. Erickson et al., *China's Future Nuclear Submarine Force* (Annapolis: Naval Institute Press, 2007), p. 243.

⁵⁵ *Ibid.*, p. 378.

⁵⁶ Friedberg, *Beyond Air-Sea Battle*, p. 37.

⁵⁷ *Ibid.*, p. 139.

⁵⁸ *Ibid.*, p. 38.

⁵⁹ *Ibid.*, p. 48.

⁶⁰ Erickson et al., *China's Future Nuclear Submarine Force*, p. 242.

⁶¹ White, *The China Choice*, p. 80.

Space does not permit us to delve into further detailed analysis of China's military deficiencies, but the examples given above demonstrate that China is unable to assert dominant military power and even in its approaches it has distinct vulnerabilities. As Beijing extends its strategic reach it does not rank as a regional—let alone global peer—competitor of America. In the event of major conflict it would face a correlation of forces that included the United States, Japan and Australia and perhaps India. And, short of major conflict, strong external balancing against China appears to be the new norm in the region, especially in Northeast Asia.⁶²

China is a continental power and, as Robert Ross has argued, China's maritime power will be limited by the constraints experienced by all land powers, including the geopolitical sources of the repeated failure of land powers to secure maritime power.⁶³ His main thesis is that land powers confront internal threats that impose severe resource constraints in developing maritime power, whereas the geographic circumstances of maritime powers offers them enduring internal border security and ready access to the sea. It is a telling point, in this regard, that China continues to spend as much on internal security as it does on its defence build-up.⁶⁴ In the Cold War, another land power, the Soviet Union, practised the same sort of access-denial capability to reduce the challenge of US carrier-based aircraft to its territorial security that China is now implementing. China has a surface fleet without organic air power and nuclear-powered submarines that remain relatively noisy.⁶⁵ Its land-based air capabilities are insufficient to enable China to project decisive power in even the relatively near waters of maritime East Asia.⁶⁶ China is not capable of challenging US dominance of regional sea lanes or the security of America's strategic partners in maritime Southeast Asia.⁶⁷

Nationalism and increasing concerns in China about its dependence on international trade for both food and energy security are driving its naval build-up. But China has the longest land borders in the world, which it shares with fourteen neighbouring countries, and it must simultaneously pursue land and naval capabilities. Failure to develop both land and sea power will constrain China's power role in world affairs.⁶⁸ In this analysis,

⁶² Ashley J. Tellis, 'Uphill Challenges: China's Military Modernization and Asian Security', in Ashley J. Tellis and Travis Tanner (eds), *China's Military Challenge* (Washington DC: The National Bureau of Asian Research, 2012), p. 19.

⁶³ Robert S. Ross, 'China's Naval Nationalism', *International Security*, vol. 34, no. 2 (Autumn 2009), p. 47.

⁶⁴ Ground forces continue to make up approximately two-thirds of China's defence spending. The People's Liberation Army is also responsible for the survival of the Chinese Communist Party.

⁶⁵ Andrew S. Erickson, 'China's Modernization of Its Naval and Air Power Capabilities', in Tellis and Tanner, *China's Military Challenge*, p. 68.

⁶⁶ China's air forces have very little aerial refuelling capability and its bombers are antiquated.

⁶⁷ Ross, 'China's Naval Nationalism', p. 55.

⁶⁸ *Ibid.*, p. 73.

the constraints on China's maritime capability will be similar to those encountered by France, Germany and Russia when they too sought maritime power. Unlike China, America can choose to prioritise maritime power in its defence spending and ensure that US naval pre-eminence continues to underpin the broader Asian order. This is a task that is not beyond the technological or innovative capacities of the United States.⁶⁹

None of this is to underrate the potential challenge to regional stability from China's military modernisation. But neither is it to succumb to the current fashion of exaggerating China's military capabilities. Despite its many achievements, China is still a weak state and, as Andrew Shearer points out, its transition to exercising influence as a sea power has provoked region-wide balancing behaviours.⁷⁰ These behaviours include hard-power balancing through the acquisition of more modern military equipment and soft power balancing by politically resisting Chinese coercion and with a shift recently from softer to harder forms of balancing through new naval and air acquisitions. As time goes on, neighbours around China's periphery may also feel compelled to field similar capabilities in order to address the growth in Chinese long-range strike assets.⁷¹ Ongoing requirements of China's naval and air forces to secure Chinese near-seas priorities make it highly unlikely that a force that is still modest in size will be able to sustain a robust top-end footprint in the far seas, no matter how much its capabilities improve.⁷²

Conclusions

In our view, China may soon be approaching the zenith of its power as its economy encounters serious structural impediments and demographic barriers to growth. This will also have important implications for the opportunity costs forgone of ever-increasing defence expenditure in a technological arms race against the United States, which Beijing cannot hope to win. Our analysis portrays a China in which worsening domestic problems will remain the leadership's highest priority and addressing such concerns will take up an increasing share of economic resources and national wealth. The Communist Party leadership will struggle to keep a lid on growing popular discontent, which may have implications for its very survival.

We have also described a lonely power that has very few friends in Asia. Although China's world view of itself is shaped by strong historic impulses of a hierarchic order with itself at the apex, very few countries in the region

⁶⁹ Tellis, 'Uphill Challenges', p. 23.

⁷⁰ Andrew Shearer, 'Southeast Asia and Australia: Case Studies in Responding to China's Military Power', in Tellis and Tanner, *China's Military Challenge*, pp. 241-75.

⁷¹ Mark A. Stokes, 'The Second Artillery Force and the Future of Long-Range Precision Strike', in Tellis and Tanner, *China's Military Challenge*, p. 160.

⁷² Erickson, 'China's Modernization of Its Naval and Air Power Capabilities', p. 96.

appear willing to concede to China the status of the dominant power. Indeed, it is more likely that countries such as the United States, Japan and India will concert together—either directly or indirectly—against an increasingly aggressive China.

In military terms, China's Achilles heel is that it lags at least twenty years behind the United States in key high-technology areas. The fact that China has no experience whatsoever of modern war and its military hierarchy depends crucially on loyalty to the Party means that China's actual war-fighting prowess must be in serious doubt. Moreover, China's military build-up is causing a classical response in kind as countries such as Japan, India and some Southeast Asian countries acquire advanced maritime military forces in order to check China.

In summary, as *The Economist* observes: China needs Western markets, its neighbours are unwilling to accept its regional writ, and for many more years the United States will be strong enough militarily and diplomatically to block it.⁷³

What does all this mean for Australia's national security planning and the forthcoming Defence White Paper in 2015? First, the most important point to make is that any suggestion the United States should move to one side in Asia to make strategic space for China should be rejected. China is not now or foreseeably a strategic peer of America's and any move by Washington to concede China's so-called legitimate strategic interests would smack of appeasement; and offered unnecessarily and for little conceivable gain. So, when Beijing proclaims that the entire South China Sea is a core strategic interest, a term traditionally reserved for Chinese claims over Taiwan and Tibet, China's maritime expansionist ambitions should be firmly resisted.

Second, Australia does not need to structure its Defence Force for war with China. Beijing is not developing the conventional forces with which to invade or directly attack Australia. But we should develop the high-technology naval and air assets necessary to contribute to any Allied conflict in the region where we might need to make a contribution or where Australia needs to help resist Chinese military adventurism. Developing these capabilities will further complicate the strategic and operational environment for a still isolated China, which will in turn place further constraints on, and likely encourage greater caution from Beijing. In Northeast Asia, this would suggest niche contributions from us in such areas as submarines and air power. Our Army cannot make a difference to conflict outcomes in Northeast Asia. Closer to home, however, we could make a much more substantial contribution by having the capability to blockade the straits of Southeast Asia in the event of a serious war in Northeast Asia involving the United States.

⁷³ *The Economist*, 23 August 2014, p. 9.

Third, short of military conflict Australia must be able to resist Chinese coercion—whether by military or other pressures—with regard to our own direct security interests, including if necessary our economic security. We also need to be capable of countering coercion in our region of primary strategic interest—particularly Southeast Asia. It is in Australia's crucial strategic interests for Southeast Asia to avoid being dominated by China geopolitically or becoming a Chinese security domain. Southeast Asia forms a strategic shield to Australia's vulnerable northern approaches and Canberra needs to place high priority on strengthening its relations with Southeast Asian countries, particularly in the defence arena, and to help them resist Chinese coercion.

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