

# ON THE HORIZON

Mapping future risks

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STRATEGIC FORESIGHT INITIATIVE

## Does Beijing Have a Strategy? *China's Alternative Futures*

As China's National Party Congress gathered in early March to anoint Xi Jinping and the next generation of Chinese leaders, Beijing's behavior at home and abroad strongly suggested that, while they have strategic goals, they have no strategy for how to achieve them. Beijing seems unable to change course from following a development model it has outgrown and pursuing assertive, zero-sum foreign policies that are counter to its long-term interests.

The poisonous pollution evident in Beijing and other major cities is an apt metaphor for the challenges facing the incoming leadership: an unsustainable status quo in a state-centric economic model that has exceeded the limits of utility; a steep environmental price being paid for thirty four years of breakneck development; and a political elite whose legitimacy is increasingly questioned by endemic corruption, a lack of transparency, and little accountability.<sup>1</sup>

Consider that China is home to seven of the world's ten most polluted cities. Then factor in a new wave of urbanization projected to add 350 million people to China's cities by 2030, bring the total urban population to about one billion. Even by the mid-2020s, there will be more than 220 Chinese cities with one million or more people living in them; by comparison, Europe today has 35. How will China manage this historically unprecedented urban

<sup>1</sup> Chinese scholars are becoming increasingly vocal, even in Western publications, on the need for and the difficulty of achieving political reform in China. See the remarkable op-ed in the *Financial Times*, March 7, 2013, by Zhang Weiying, "China Must Seize Rare Opportunity for Reform." <http://www.ft.com/intl/cms/s/0/f0c375d0-8596-11e2-bed4-00144feabdc0.html>

### STRATEGIC FORESIGHT INITIATIVE

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expansion with its huge increase in demand for energy and other resources and its likely environmental impact?

Chinese leaders at every level face a growing credibility and accountability crisis from a rapidly expanding middle class that harbors rising expectations and festering resentment over corruption, environmental damage, and increasing inequality—and is empowered by more than one billion cell phones, 550 million Internet users, and 500 million people on Wei Bo, China's Twitter-like micro-blogging service.

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## Modern China or Dystopia?

Chinese leaders are well aware of the great challenges they face, but it is not clear they have a way or the political will to adequately address the task of shaping a successful future. All told, Beijing's behavior appears a far cry from Western imagery of a far-sighted China guided by Sun Tzu and a long-term strategic calculus.

China is on a trajectory that will be hard to change. The continuing growth in energy consumption implied by China's rapid urbanization helps explain why, despite large-scale investments in nuclear, wind, and solar power, 70 percent of its energy still comes from coal, a percentage that has remained steady over the past two decades. Although Chinese leaders would like to promote energy-efficient green cities like New York, the locals are building urban/suburban sprawl like Los Angeles with individual car ownership at the core of the transportation system and city planning.<sup>2</sup>

Chinese leaders are also painfully aware that this growing energy demand will likely further exacerbate environmental degradation. In a rare bit of candor, Wang Yuesi, an atmospheric physicist and member of a government working group on haze reduction, told the *Financial Times* that "coal burning and car emissions" interacting with a particular weather pattern were the immediate cause of the problem. But remarkably Wang added, "Only if reform of the political system is put on the agenda will the economic system and the [environmental] management system be able to catch up."<sup>3</sup>

## Xi: A Reform Agenda?

The legitimacy of the ruling Communist Party has been based on performance, and more than three decades of double digit economic growth has been the foundation for the success of this de facto social contract. But the development model that has delivered this success has run its course. This was the premise of *China 2030*, a report last year cosponsored by the World Bank and the Chinese State Development and Reform Commission

<sup>2</sup> See Tom Miller, *China's Urban Billion*, Zed Books (London, 2012), for the dimensions of the problem.

<sup>3</sup> Leslie Cook, "Scientist Hits Out Over China Air Quality," *Financial Times*, January 17, 2013, <http://www.ft.com/intl/cms/s/0/e048f7e4-6083-11e2-a31a-00144feab49a.html>



*Pudong has become the engine of economic and social development in Shanghai. Photo credit: Banning Garrett.*

(SDRC), a leading policy body.

The report argued that, if China is to become "a modern, harmonious, creative, and high income society," it must adopt "a new development strategy" that includes strengthening the rule of law, a greater role for private markets and "increased competition in the economy." Importantly, the strategy argued that "reforms of state enterprises and banks would help align their corporate governance arrangements with the requirements of and permit competition with the private sector on a level playing field."<sup>4</sup>

The strategy also argued for a new strategic direction of "green growth," viewing environmental protection and climate change mitigation not as burdens on growth, but as growth opportunities. Beyond the toll on the health of its citizens, it is estimated that environmental damage subtracts about 5 percent from the reported annual GDP.

<sup>4</sup> See World Bank, *China 2030*, p.xvi: <http://www.worldbank.org/content/dam/Worldbank/document/China-2030-complete.pdf>

## Political Inertia?

Although newly-installed President Xi Jinping and Premier Li Keqiang, along with some members of the standing politburo, are viewed as likely reformers, thus far there are few signs that a sea change in China's approach to development is in the offing. The Chinese political elite is part of a wide network encompassing those at the top of its state banks and state-owned enterprises and PLA-affiliated interests. Thus, it is no surprise that China's major state-owned oil companies have successfully lobbied against enforcing higher fuel efficiency standards, even as the number of autos in Beijing has jumped from 3 million in 2008 to over 5 million in 2012.

This points up the dilemma of China's new leadership. It knows that it needs to pursue far-reaching reforms that will significantly impact the benefits much of China's upper echelon enjoy, but it has not mastered navigating among competing interest groups. Instead, recent efforts to keep economic growth in the 7-8 percent range have involved more stimulus spending, with state banks funneling RMB to Chinese state-owned industry, much of it into construction to sustain employment. The result may be a residential real estate bubble, with millions of houses, apartments and dozens of malls that sit as empty ghost cities and which the flood of rural immigrants can ill afford. The bubble has been fueled by structural challenges difficult to fix.

Only now has China begun to impose a 20 percent tax on residential property aimed at managing the bubble of ever-rising prices that has led to huge real estate investments by SOEs and corrupt party officials, fueled by cheap money, no property taxes, and politically-directed bank favoritism. Many in the middle class, with few other investment opportunities, were also enticed to buy apartments as a place to park their savings and watch them grow.

There are clearly scholars and officials in China who understand these dilemmas and are acutely aware of the need for political reform to achieve economic objectives and maintain social stability. In a remarkable op-ed in the *Financial Times* published during the NPC meeting in Beijing, Peking University economics professor Zhang Weiyang wrote, "The challenge of reform is a tough one for

the new leaders. After a 'lost decade' under Mr. Hu, the country is much less harmonious. Curbing corruption, improving income distribution and maintaining economic growth are all urgent. But it is widely argued by academics and, privately, by many officials that the priority is starting the long-delayed shift to a constitutional and democratic system. Otherwise, China will lose its economic momentum and its social stability."<sup>5</sup>

These unresolved, politically intractable internal dilemmas faced by Chinese leaders may be contributing to Beijing's nationalist rhetoric and assertive behavior regarding disputed islets in the East China Sea (with Japan) and South China Sea (with the Philippines, Vietnam, and Malaysia). It may be a popular short-term distraction, but it will not alleviate pressures for change.

Moreover, China's assertive activities in the region and reflexive strategic competition with the United States are undermining the peaceful international environment it needs now and will continue to need for the foreseeable future as it struggles with its internal challenges in an increasingly interconnected and interdependent world.

In the aftermath of the 2008 financial crisis, Deng Xiaoping's dictum that China needs to maintain a peaceful external environment to focus on development, was considered passé by many Chinese hardliners. They viewed China as emerging relatively stronger than the United States, which they saw on an accelerating trajectory of inevitable decline. For many of the nationalists, China had long enough "swallowed the bitter pill" of hiding its strengths and laying low and it was time to push back.

It is difficult to discern coherent Chinese strategy in all this beyond a venting of nationalistic frustration based on historic grievances and a new-found sense of hard power. What positive outcome do some Chinese decision-makers expect from an assertive China confronting the United States and its allies from cyber hacking to maritime provocations? So far, this behavior has led its neighbors to question its intentions and seek to strengthen a counterbalancing network of actors led by the United States. While

<sup>5</sup> Zhang Weiyang, "China Must Seize Rare Chance to Reform," *Financial Times*, March 7, 2013, <http://www.ft.com/intl/cms/s/0/f0c375d0-8596-11e2-bed4-00144feabdc0.html>

many in China cite the US “rebalancing” policy toward Asia as the cause of tensions in the region, the reality is the opposite: China’s assertive activities and posture in regard to long-disputed island territories have generated a strong Asian reaction. In effect, China has sparked the exact opposite result of what it intended, a sort of self-containment.

China’s decision-making remains opaque. But as its decisions to throw massive amounts of money at construction-centered stimulus plans may reflect party-state vested interests, its political-military behavior may partly reflect China’s own military-industrial complex pushing its narrow interests and prerogatives bolstered by two decades of military modernization backed by double-digit growth in defense spending. While Beijing defends its behavior as reactive to provocations from Japan and others, it apparently fails to understand that others often view its rhetoric and action as those of an aggressive bully backed by rapidly expanding military power and the region’s largest economy.

### **What Futures?**

China’s leadership thus appears to be lacking the ability or will to implement coherent and sensible domestic and international strategies that serve its self-proclaimed interests in peace and development. At the same time, many in Beijing understand that China needs a cooperative relationship with the United States not only to ensure a peaceful environment for its economic and social development during a difficult period ahead, but also to confront the global challenges no nation can manage unilaterally. They—and many of their counterparts in the US—recognize that a more cooperative US-China relationship is essential for the future of both countries. They also recognize that the global future will be significantly determined by the future of the relationship between the United States and China, the world’s two most important countries, two largest economies, and two largest consumers of energy and emitters of carbon.

There are reasons for optimism that the leadership transition in China and the re-election of US President Barack Obama may offer a new opportunity for developing long-term collaborative relations. There are also many reasons to

worry, however, that the two countries’ disputes, strategic mistrust, and near-term concerns could overwhelm the strategic logic that calls for long-term cooperation.

### **Reasons for Optimism**

As often noted, periods of power transition push politicians to demonstrate “toughness” on foreign policy, especially toward perceived rivals or threats. Once these periods are over, politicians usually dampen the rhetoric and feel freer to pursue moderate policies guided by national interest, not nationalism and emotion. The political transition in Beijing is now formally complete. Many Chinese intellectuals and officials have been advising American visitors that Beijing’s assertive posture is a creature of China’s transition politics. If so, there is diminished pressure on Xi as well as on Obama to take a tough stand on bilateral relations.

The 18th Chinese Party Congress Report called for “a new type of power relationship” and included vague phrases about global challenges, common interests, and a common destiny. This may be empty rhetoric, but it merits testing by the Obama administration and the G-20 nations.

### **Reasons to Worry**

Persistent strategic mistrust poses a major obstacle to far-reaching cooperation between Washington and Beijing. There are “realists” on both sides who see inevitable conflict between a rising power and an established hegemon vying for global dominance, perhaps even leading to military conflict. Each portrays the other’s intentions as a strategic challenge and inherently hostile to its interests. Many Chinese strategists argue the United States is committed to keeping China weak and divided through a containment policy and claim the US “pivot” is further proof of this intention.

American strategists see China bent on dominating Asia and sharply curtailing US presence while seeking to bully US allies and friends in the region. Both can point to evidence for their analysis based on actions or statements of the other side. The relationship is also plagued by persistent bilateral disputes, from trade and investment issues to Taiwan, human rights, and, increasingly, cyber espionage and industrial intellectual property theft. These disputes have strengthened nationalist forces in both countries opposed to closer ties.

## Rethinking the US-China Relationship

The strategic logic for building a US-China partnership is appreciated on both sides of the Pacific. However, the ability of Xi and Obama to rebalance the relationship so that it becomes predominantly cooperative rather than competitive is highly uncertain, buffeted by contending interest groups and other political forces pulling in contradictory directions.

In addition to sustained cooperation on long-term global challenges, there are a host of compelling near-term issues progress on which could put the relationship on a path toward a more cooperative “new type of great power relations.” On all of the issues below there is, at least in theory, ample common ground to find a balance of interests both the US and China can live with:

- *Afghanistan/Central Asia:* As the US winds down its military presence in Afghanistan, China, which has substantial economic investments and has been free-riding on the US security presence, needs to rethink its approach. Overlapping interests in Afghan stability, counter-terrorism, and support for economic integration in Central Asia shape a potential agenda for new regional dialogue and cooperation. In particular, both countries need to work together to ensure the stability and development of Pakistan, a Chinese ally whose potential loose nuclear weapons pose a threat to global as well as regional security;
- *Cyber-Security:* Cyber espionage and probing attacks are proliferating and a realm where agreement on global rules and norms is desperately needed. The United States and China have a mutual vulnerability, and at the strategic level could benefit from moving from obfuscation on the issue to a serious dialogue aimed at establishing codes of conduct and accepted norms, as officials from both sides have recently suggested;
- *Greater Middle East:* The ongoing transformation in the Middle East and North Africa should be an area of overlapping US and Chinese interests in stability and accountable governments that are not hostage to extremist forces. Syria is the most pressing test case

for Sino-American cooperation;

- *East Asia:* There is an urgent need to create a new *modus vivendi* and rules of the road on what sort of US military footprint in the region China can live with, and vice-versa. The current path of increasing military competition, with US fears China is pursuing an anti-access strategy and Chinese fears of US containment, is a road to nowhere with deepening mutual mistrust and increasing chances of a potentially catastrophic confrontation.

## Alternative Futures for China

The stakes are high for the US “to get it right” with China, and for China to “get it right” with the United States and internally. It is in US interests that China does not falter much less fail economically, just as China has a vital interest in US economic success. How the US deals with China—and how China manages its internal transformation—will have a major if not decisive impact on which future scenario China evolves towards over the coming generation. We present three alternate futures for China not as predictions but as useful heuristic tools to think about possible outcomes of current strategic and policy choices: Harmonious World, Muddle Through, and Middle Income Trap.

- **Harmonious World:** In the best-case scenario, China’s new leadership begins over the next five to six years to strengthen the rule of law, move its financial system to a more market-based allocation of resources, and allow the RMB to become convertible and ascend as a global currency. Consumer-driven growth sustains a 6-7 percent annual growth rate as China decreases its reliance on exports and increases social stability through political and judicial reform to open up the political system and enhance rule of law, transparency, and accountability. Internationally, as China and other G-20 nations push for a larger voice in rule-making, they cooperate with Western countries to strengthen the international rules-based order even as they revise the rules. China also finds a new, more stable and cooperative *modus vivendi* in East Asia not only with the United States but also its Asian neighbors, enhancing prospects for regional security and for

cooperation on global issues. In addition, China plays a key role in devising new rules and codes of conduct on cyber and space policies. In this “harmonious” world, the US-China relationship is both a critical element in achieving this positive outcome for China and also a beneficiary of China’s success in restructuring its domestic economy and pursuing a conciliatory and cooperative foreign policy.

- **Muddle Through:** This future features a crisis-reaction rather than strategy-driven China in which the leadership responds with limited effectiveness to environmental crises, bursting of the residential real estate bubble, corruption, and increasing inequality and social discontent. China engages in reform by default more than by design. In a decade-long journey over a bumpy road, China slowly takes steps to enhance the rule of law, increase accountability of local and regional party officials, and gradually reform the economic and financial system to enhance competitiveness, reduce the monopoly power of the SOEs, and take other steps, reluctantly and belatedly, to restructure the economy and slow if not halt the trend of increasing inequality. This future is characterized by a reactive foreign policy that is a mix of nationalism, caution, and both cooperation and competition with the United States with little willingness in Beijing to engage in far-reaching collaboration with the United States and other powers to address global challenges.
- **Middle Income Trap:** Pressures to sustain 7-8 percent growth result in more excessive and politically-motivated, unsound lending by state banks to keep the economy appearing to be growing while increasing the debt load and engaging in unproductive investments. This proves counter-productive and hits a wall as the residential real estate bubble bursts, middle class investors who put their savings into buying apartments are hit hard, social unrest grows, and China’s real growth drops radically to the 2-3 percent range and unemployment skyrockets. China falls into the middle income trap as it fails to move up the value chain in production to compete with advanced countries and yet its higher wages render it unable to compete with other developing countries. As China focuses

increasingly on internal challenges, including social unrest and political instability, it tends to view the outside world as a source of its problems and a strategic threat, thus stoking nationalism and increasing intransigence in its relations with other states and in international fora. The US and China find it increasingly difficult to cooperate on critical issues while mutual suspicions deepen.

Deng Xiaoping urged China to “cross the river by feeling for stones,” an approach that for the most part has been followed by his successors. But it is at best uncertain whether this cautious pragmatism will be sufficient to navigate China’s uncertain future to avoid the Middle Income Trap and go beyond Muddling Through to achieve a Harmonious World outcome.

The United States needs to avoid *schadenfreude* as China faces increasing difficulties in the future and recognize that US interests are best served by a successful, not failing, China, and that a successful China is more likely to eschew extreme nationalism in favor of bilateral and global cooperation with the United States. China experiencing a sharp economic decline and resulting political and social instability, would likely have a devastating effect on the global economy and on international stability and security. In short, hoping for or seeking to promote failure or a sharp decline in China’s fortunes could lead to mutual assured economic destruction as well as to global governance gridlock in the face of mounting global challenges threatening the prosperity and security of China, the United States and all other nations.

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*Some of the material in this report previously appeared in a Yale Global article by Mr. Manning.*

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