

The Uno Newsletter: Rejuvenating Marxian Economics through Uno

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## **The Emergence of China and India as Great Powers**

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## Executive Summary

It has been widely predicted that China will soon overtake the USA to become the world's largest economy, and that India will overtake the USA within fifty years or so. Such optimistic projections have been thrown into doubt by recent macro-economic events in these countries, although most observers believe that China will overcome its present difficulties. There is less confidence about India.

This paper discusses briefly the economic and political obstacles to rapid economic growth in China and India. On the assumption that China and India will surmount these obstacles and return to their projected growth paths, they will both become great economic powers by mid-century. The paper explores some of the implications of such a development for the rest of the world. Attention is focussed on the following issues.

- *International Trade.* This section provides a brief survey of the widely discussed impacts of Chinese and Indian economic growth on world trade. As China moves up the value-chain, it will phase out its labour intensive exports and focus on more “knowledge-intensive” products. This will create new competition for established makers of knowledge-intensive products in today's advanced economies, but it will also create new demand for labour intensive-products from the poorer countries of South Asia, Sub-Saharan Africa and elsewhere. Primary commodity prices are another important issue. Commodity prices are still at a high level due to the additional demand resulting in part from the impact of Chinese and Indian economic growth. However, it is uncertain how fast such prices will continue to increase in the future. Because of new supply and demand side developments, it is possible that the real price of commodities such as oil and gas will stabilise or even fall over the medium term.
- *International Investment.* This section documents the scale and location of outward direct investment by Chinese and Indian firms. Despite the attention it has received, Chinese investment in the rest of the world is still relatively small, even in Africa where it has been a cause for alarm in the Western media. The scale of Indian investment is even smaller. Outward investment by Chinese and Indian firms is growing rapidly, but it will be a long time before their overseas operations compare in scale to those of their established rivals from more advanced economies.
- *Is there a New Imperialism in the Making?* This section considers two issues that have classically been associated with the concept of imperialism: global rivalry between large firms; and colonial-style exchange in which industrial powers exports manufactured goods to impoverished countries in return for oil, minerals and other primary commodities. As Chinese and Indian firms expand overseas they will be drawn into global rivalry with other large firms, and like other firms they will draw upon their “home” governments for support. It is also the case that China, and to some extent India, has a colonial-style division of labour with many poor resource-based economies, especially in Africa, which import cheap labour-intensive manufactures from China in exchange for oil and minerals. However, this is only part of the story, since the money used to purchase cheap Chinese manufactures is often

derived from oil and mineral exports to non-Chinese destinations in Europe and elsewhere.

- *The Military Balance.* The emergence of China as a great economic power is provoking a shift in the military balance in the Asia-Pacific region. Concern about China's increasing strength and assertiveness is leading many countries in the region to upgrade their own military capabilities. The United States has also announced a rebalancing of its strategic priorities with greater emphasis on the Asia-Pacific region. China has one great advantage in this context. The United States is a global power which, despite its new priorities, cannot afford to divert too many of its military resources to the Asia-Pacific region. In contrast, China's military objectives are, for the time being at least, mainly confined to its geographical periphery where it can concentrate its armed forces. China is a long way from becoming a truly global military power, but is already a major regional power. As China grows stronger, this will confront both its neighbours and the United States with difficult strategic problems. Containment of China is the obvious kneejerk reaction, but a better response may be to seek a more cooperative solution in which China and the United States share leadership as equal partners, perhaps in concert with other major powers such as India and Japan. It is an open question how far such an arrangement would be acceptable to the parties concerned.

Despite its large GDP and its newly acquired status as the world's leading exporter of goods and services, China is still what David Shambaugh calls a "partial power"<sup>1</sup>. It has few truly global companies and the overseas operations of Chinese firms are still small in comparison with those from the advanced economies. In military terms it is no match for the United States on a global level, although it is a strong regional power in its immediate maritime periphery. If China continues on its projected trajectory, Chinese firms will continue their outward expansion and the Chinese military will acquire the capacity to act effectively on a global scale. China will then become a truly global power. The same observations apply in principle to India, although there is more uncertainty about its future growth prospects. Even if it does return to its projected growth path, India will take much longer than China to become a global power.

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<sup>1</sup> Shambaugh (2013)

## 1. Take-off

By any standards China's modern economic growth has been remarkable. Growth has been widely spread across the country and not merely concentrated on the coastal region where most export industries are located. As a recent World Bank report noted, if mainland China's 31 provinces were regarded as independent economies, they would be among the 32 fastest-growing economies in the world<sup>2</sup>. China has grown somewhat faster than Korea and Taiwan at a similar stage of development, but its trajectory has been broadly similar with a lag of about 25-30 years. Indian economic growth has also accelerated, although its per capita income is currently well below that of China. The causes and exact timing of the Indian take-off are a matter of debate, but there is no denying that the economy has grown at a rapid if irregular pace for most of this century<sup>3</sup>.

## 2. Future Economic Growth

Forecasting is a hazardous activity and projecting economic growth is no exception. In the 1980s, it was widely thought that Japan was poised to overtake the USA in terms of technology and per capita income. But this did not happen. On the contrary, Japanese growth faltered and the country entered a long period of near stagnation. The Soviet Union provides an even more dramatic example. With its impressive post-war expansion and its achievements in areas such as space technology, the Soviet Union was regarded by many as a formidable rival to the West. However, even its strongest critics did not expect its spectacular implosion during the Gorbachev era and its subsequent economic travails. These examples should be a warning against uncritical acceptance of the many optimistic long-range projections that are now available regarding future economic growth in China and India.

Such projections assume that both China and India will successfully meet the various challenges that will confront them in their pursuit of continued economic growth. These challenges can be conveniently divided into "economic" and "political", although in practice these are interrelated. The following is a brief survey.

### *China*

*Economics:* Following the financial crisis in the advanced economies, Chinese exports slumped in 2009 and the government responded by ramping up the investment rate to an unprecedented 48 per cent of GDP. This was accompanied by a massive increase in the volume of credit in the economy from around 125 per cent of GDP in 2008 to over 190 per cent in 2013<sup>4</sup>. Much of this credit has come from the poorly regulated shadow banking sector and the financial system as a whole is now somewhat unstable. The Chinese authorities are aware of the danger and are seeking to contain the growth of credit and prevent a financial crash.

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<sup>2</sup> World Bank (2013), p. 5.

<sup>3</sup> For a good discussion of this issue see chapter 3 of Corbridge et al (2013)

<sup>4</sup> IMF (2013a) page 11, Figure 4.

It is widely accepted that much Chinese investment in recent years has been misdirected and will be ultimately wasted<sup>5</sup>. It is also agreed that the old model of growth driven by investment and exports is no longer viable and there is a need to shift to a slower, high consumption growth path. This requires a higher share of both private and public consumption in GDP. The transition may not be easy, although other countries, such as Korea and Taiwan, have managed it in the past. The task may be more difficult in the case of China because its investment rate is currently much higher than the highest investment rates ever recorded by Korea and Taiwan which peaked at around 40 per cent of GDP.

A major challenge facing China in the medium term will be to avoid the “middle income trap”. The historical evidence suggests that after an initial development spurt, the growth rate of most countries slows down sharply and they fail to break through into the high-income class<sup>6</sup>. Only a minority of countries, including Korea, Singapore and Taiwan, have avoided this trap. During the initial phase of development, it is relatively easy to raise per capita income by investing heavily in infrastructure and productive capital, and by transferring excess workers out of agriculture, where their marginal product is close to zero, into more productive activities such as construction and manufacturing. The next phase is more difficult since it requires sustained productivity growth within individual sectors of the economy, especially the service sector where most of the labour force will soon be employed. Within the manufacturing sector it involves a shift towards higher value-added production.

China has not yet reached this turning point. Although depleted, its agricultural reserves are still substantial, so there are still gains to be had from transferring labour from farming into other economic activities. However, the end of the initial development phase is in sight and over the longer term continued growth in per capita income will require major improvements within individual sectors of the economy. It is also becoming more difficult to raise productivity through investment in fixed capital or the imitation of foreign countries, so the key to future growth will be innovation and greater efficiency in the use of capital. A recent joint report by the World Bank and Chinese researchers argues that this can be best achieved through the partial or complete de-regulation of many markets, increasing competition for state owned enterprises, increasing private participation in these enterprises, and giving the private sector a much greater role in the economy<sup>7</sup>. This is a familiar World Bank refrain.

The need to shift towards slower growth and to a more market-based, consumption-driven economy is a theme in the 12<sup>th</sup> Five Year Plan. The Plan also recognises the importance of services and intangibles such as R&D and education, and it stresses the need for upgrading to higher value-added and more environmentally friendly products and methods of production. The Plan identifies 7 priority industrial areas<sup>8</sup>. Three areas align with the aim of sustainable growth: energy savings and environmental protection; new energy; and clean energy vehicles. The other areas are consistent with China’s ambition to move up the value-chain: biotechnology; new materials; new IT; and high-end manufacturing.

The 12<sup>th</sup> Five Year Plan is an impressive document. It reflects a clear understanding of the direction in which the Chinese economy should move and of the popular needs that must be

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<sup>5</sup> See Lee et al (2012)

<sup>6</sup> World Bank (2013), p. 12.

<sup>7</sup> World Bank (2013)

<sup>8</sup> The following summary is taken verbatim from KPMG (2011).

addressed. Since the publication of the Plan, there have been new policy initiatives, such as the right of farmers to "possess, use, benefit from and transfer their contracted land, as well as the right to use their land ownership as collateral or a guarantee."<sup>9</sup>

*Politics:* The fulfilment of the 12<sup>th</sup> and future Five Year Plans is predicated on continued political stability. This presumes that either the existing political system will continue largely unchanged or that any major change will be carried through without serious disruption. The leadership is aware of possible threats to stability and seeks to learn from events such as the collapse of communism in the Soviet Union and Eastern Europe or the mass upsurge of popular discontent in the Middle East and elsewhere. To minimise such dangers the leadership aims to address the sources of material discontent, to make the party apparatus more responsive to popular demands, to strengthen the rule of law and to reduce corruption and arbitrary behaviour, whilst maintaining tight security control. This should work in the short-term but whether it will work over the longer-term is an open question. There are various possibilities. China may retain the present one-party political system. Or it may eventually go down the road pioneered by Taiwan in the 1980s, where a centralised political organisation, the Guomindang, surrendered its monopoly of power and allowed the formation of rival parties. The transition was fairly smooth in Taiwan but whether this would be the case in China is uncertain. Taiwan is a small country with a population of 23 million. What is feasible in Taiwan may be impractical in a large country like China with a population of 1360 million and fractious ethnic minorities in Tibet and Xinjiang (East Turkestan). The regime may even be brought down by an explosion of popular discontent as in the so-called Arab Spring. This seems unlikely now but who can say what will happen in twenty years' time? There are also other possibilities, but this is not the place to speculate about them<sup>10</sup>. Suffice it to say, that China may surprise us all.

## ***India***

*Economics:* India's 11<sup>th</sup> Five Year Plan 2007-2012 was a qualified success. Although some important targets were missed, overall GDP growth averaged 8 per cent over the plan period as a whole. However, the Indian economy took a sharp turn for the worse during the closing year of the Plan. GDP growth slowed to 3.2% p.a. in the fiscal year 2011-12 and there are now serious macro-economic imbalances. The government fiscal deficit has exceeded 8% of GDP for some years, the inflation rate is over 10% p.a., the rupee has depreciated sharply, and there is a balance of payments deficit equal to 5% of GDP.

The above imbalances are openly recognised in the new Draft Five Year Plan<sup>11</sup>. It also points to infrastructure as a crucial bottleneck if India is to achieve the hoped for 8 per cent p.a. growth in GDP and almost double digit growth in manufacturing. The failings of India's infrastructure, especially in electricity and transport, are well-known. The electricity supply is limited in coverage, and where there is a supply it is often unreliable and subject to black-outs. Difficulties with the transportation of coal, which is the main fuel used for power generation, help to explain why the electricity system is so unreliable, although other factors such as a lack of installed capacity are also important.. In the case of rail, many projects are subject to long delays and cost over-runs. Only 1,750 km of new lines were added from 2006 to 2011, as compared to 14,000 km in China. Ports are congested and are operating at 90% capacity as compared to a global average of 70%. Only 24% of National highways have four

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<sup>9</sup> Xinhua News agency cited in CNBC (2013)

<sup>10</sup> See Beardon (2013), chapters 7 to 10

<sup>11</sup> Government of India (2012a)

lanes<sup>12</sup>. In all of these areas the 11<sup>th</sup> Five Year Plan failed to reach its targets, whereas targets for airports and telecommunications were exceeded. Looking forward, infrastructure investment is supposed to rise from 7.2 % of GDP under the 11<sup>th</sup> Plan to 8.2% of a much larger GDP under the 12<sup>th</sup> Plan. If this could be achieved there would be a major improvement in India's infrastructure of all kinds.

There are also other obstacles to growth. Bureaucracy is a perennial problem. Small and medium size enterprises find it difficult to obtain finance from the banking sector. The education system needs improvement at all levels. Only 88% of men and 74% of women aged 15-24 are literate, as compared to 99% in each case in China.

*Politics:* India is the world's largest democracy. It has many flaws and its politics are a kaleidoscope of rival ethnic and regional parties. Patronage and corruption are widespread, the bureaucracy is cumbersome, and the provision of public services such as health and education is patchy<sup>13</sup>. There are huge inequalities of income and wealth with hundreds of millions of people still living close to or below the poverty line. There is also an unusual level of political violence for a democracy. Maoist guerrillas are active in many parts of the country and there are on-going conflicts between the army and separatists in Kashmir, and between tribal peoples and settlers in Assam. There are occasional pogroms against non-Hindu minorities, such as Sikhs, Muslims and Christians. A prime minister, Indira Gandhi, was even assassinated by her Sikh body guards in 1984.

Despite all this, elections are held and turnout is reasonably high by international standards. In the 2009 Indian general election 417 million people voted. The turnout was 56.5% of the population of electoral age which compares favourably with the turnout of 53.6% in the 2012 American presidential election. A surprising feature of Indian politics, until now at least, has been the ability of the state to formulate and implement ambitious plans for economic growth despite the fragmented party structure. Hopefully, this state of affairs will continue.

### ***Projections: common features***

Most long-range projections of future growth in China and India assume that the above obstacles will be successfully overcome. These projections differ in terms of method and time horizon but they mostly agree on the following points:

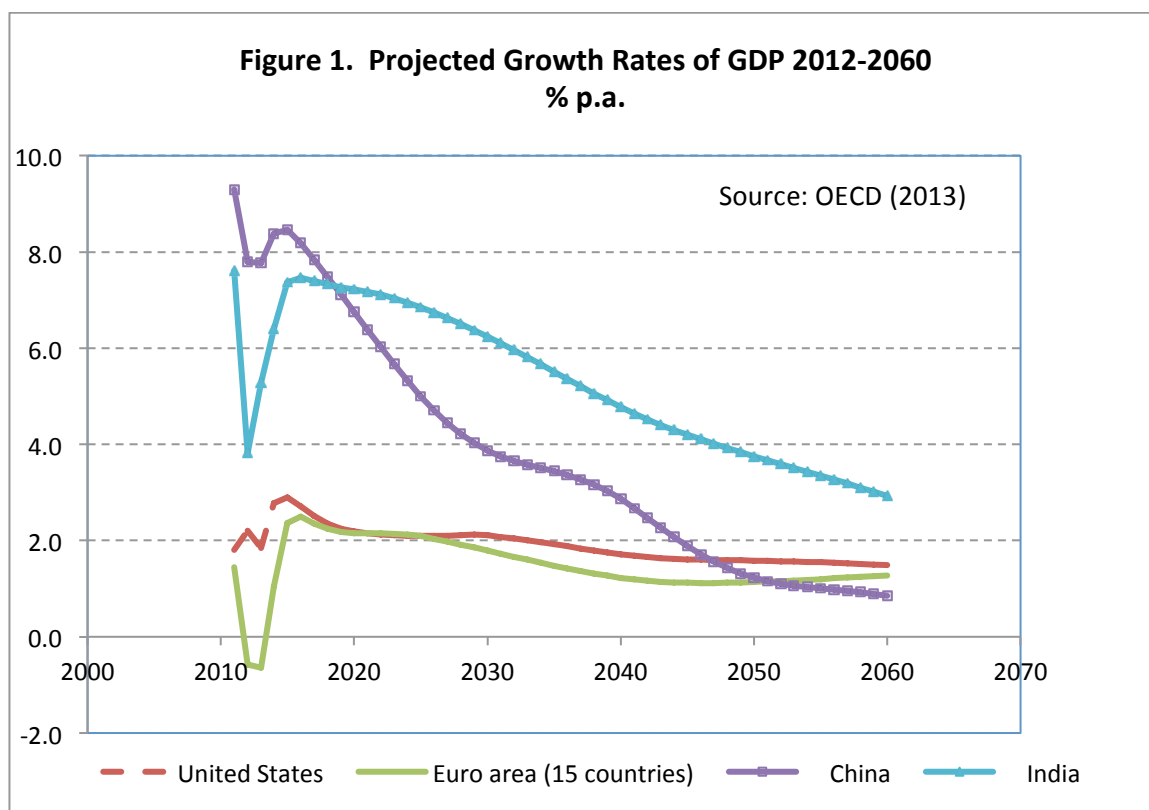
- *Rapid growth:* China and India will overcome their current macro-economic difficulties and will grow relatively fast by international standards for the next few decades.
- *Future slow-down:* The rates of economic growth of China and India will slow down as they become richer. This is partly because they will have less scope for catching up by adopting easily imitated technologies from more advanced economies. It is also because reserves of excess labour will become depleted in the course of time and an increasing fraction of the labour force will be employed in the service sector where it is more difficult to raise productivity.
- *India will slow down later:* India is poorer than China and will be later to reach the turning point at which per capita income growth normally decelerates.

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<sup>12</sup> Ernst & Young (2012)

<sup>13</sup> India ranks 94<sup>th</sup> out of 176 countries in the 2012 Transparency International Corruption Perceptions Index (Transparency International, 2012). This index measures public sector corruption.

- *India's demographic advantage:* The Chinese population of working age (20-69) is on the verge of decline, whereas that of India should continue growing at least up to mid-century. According to UN projections (medium variant) the population of China in this age group is projected to fall rapidly from a peak of almost 1,000 million in 2020 to 620 million by the end of the century, by which time India should have fifty per cent more people in this age group than China<sup>14</sup>. Provided they can be usefully employed, this additional working-age population will give India's overall GDP a boost. However, a larger population will put an increasing strain on the environment and it may prove difficult to employ all of these people productively.



### **OECD projections**

The OECD has produced annual projections of total GDP and GDP per capita for China, India and certain other countries up to 2060<sup>15</sup>. These projections are representative of what is currently available in the field. The OECD projects that the growth rate of per capita income in China will decline from around 8% p.a. in 2015 to 1.6% by 2060. The decline is even more striking in the case of total GDP. By the end of the period Chinese population will be falling, and this pulls down the growth rate of total output to only 0.9% p.a. by 2060. This is below the rates projected for the USA and the Eurozone (Figure 1). Following a sharp recovery from recent difficulties, the Indian economy is also projected to experience falling growth

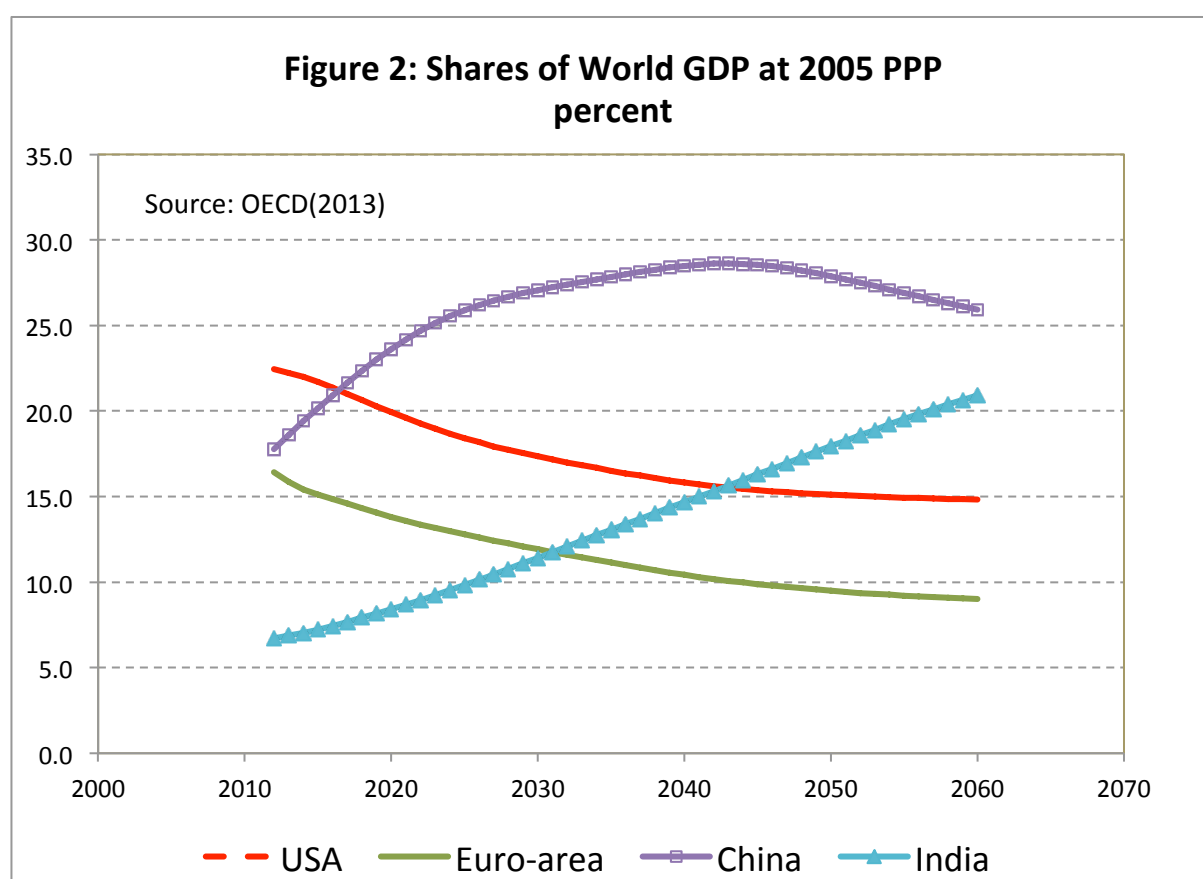
<sup>14</sup> UN (2013). The Chinese government has recently announced a partial relaxation of the one child policy (Xinhuanet (2013a). This change in policy is foreshadowed in the UN projection cited in the text which assume some increase in the Chinese total fertility rate over the next few decades.

<sup>15</sup> OECD (2013)



rates, although the pace of decline is much slower than in China. From around 2020 India starts to overhaul China in terms of both in per capita income and total GDP.

The above growth rates have dramatic consequences. By 2060 China is approaching the Eurozone average in terms of per capita income, although it remains some way below the US level. Because of its huge population, China's total GDP soon outstrips that of any other country. China's share of world GDP peaks in 2043 and then falls back to around 28 per cent in 2060 (Figure 2). India starts off well behind China and, despite faster growth rate it fails to close the gap completely by the end of the projection period. Even so, in terms of total GDP it easily outstrips the Eurozone and just overtakes the USA by the early 2040s. Assuming these projections are correct and can be extrapolated beyond 2060, they imply that shortly after 2070 India, with its larger population, will overtake China to become the largest economy in the world. These projections are highly speculative and should be treated with caution. For India to catch up with China it would have to overcome its current macro-economic and longer term structural difficulties and return to the kind of growth trajectory forecast by the OECD. This is by no means certain.



#### 4. International Trade

It is now a commonplace that as China develops it will move up the value-chain into more “knowledge-intensive” activities. Exports of labour-intensive goods such as clothing are still rising, and many of China's more sophisticated exports, such as consumer electronics, still have a significant local labour-intensive content. But wages are increasing rapidly and such labour-intensive activities will be phased out as China loses the ability to compete with

cheaper foreign producers. Korea and Taiwan reached this turning point in the late 1980s, and both of them eventually became net importers of clothing and the like. Given that China is following a similar trajectory to these countries with a lag of about 25-30 years, this would suggest that labour-intensive exports from China may be approaching a peak. Their share of exports is already falling but it may not be long before they start to fall in absolute terms.

These developments will affect the rest of the world in various ways. China will become a leading producer of sophisticated goods that were previously the preserve of highly developed economies. It will be a formidable competitor in both foreign and home markets, and its recent success in the market for solar panels will be replicated in many other fields. Many established producers in the developed economies will lose out. However, others will gain from the extra demand generated by Chinese growth. Provided China does not hoard its growing export revenue but spends it on imports, then somebody somewhere will be selling more goods or services to China. This someone may be a German firm selling luxury cars to China, or it may be an Australian firm exporting minerals to China. No matter how successful China is in the future, it will not impoverish the whole of the world by exporting. There will be gainers and losers. Some foreign producers will lose, but others will gain. Amongst the countries likely to face the biggest challenge will be Japan and Korea which rely heavily on exports of capital goods and intermediate goods to China. As China develops it will produce many of these items for itself, often with the help of Chinese and Korean multinationals, thereby reducing the need for imports.

As China moves up the value chain, this will create space for other countries to take over the abandoned activities. Some will be established exporters, such as Bangladesh, Indonesia or Viet Nam, whose exports of clothing, for example, have been rising strongly in recent years. India is also a contender. Despite recent growth, India's labour-intensive exports are still small in relation to the size of its economy and there are huge reserves of underemployed labour that could be used to produce labour-intensive manufactures for domestic consumption and export. Africa is also a possibility. Wages are now comparatively low in some Sub-Saharan countries and if other conditions could be sorted out these countries would be attractive locations for labour-intensive manufacturing. This issue is discussed below.

The industrialisation of China, together with India and certain other developing countries such as Brazil, has created a hunger for primary products, especially oil and minerals. This helps to explain why most commodity prices are currently much higher in both absolute and real terms than they were twenty five years ago. It is difficult to know what will happen in the future. Predicting the long-run (or short-run) behaviour of commodity prices is notoriously difficult since these depend on both supply and demand, and there are so many unknowns involved. This is illustrated by the wide range of projected outcomes in the various long range forecasts of the American Energy Information Administration. In its reference scenario, the EIA projects that world energy consumption will grow by 56 per cent between 2010 and 2040<sup>16</sup>. Half of the increase is attributable to China and India. This projection assumes that the real price of oil will rise by approximately 45% over the period. In addition to its reference scenario, the EIA presents high and low oil price scenarios under which oil prices in 2040 differ by a factor of more than three. There is also considerable uncertainty about the trajectory of world energy consumption although the range of variation is much less than for prices.

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<sup>16</sup> EIA (2013), slide 2.

Higher prices stimulate economy in the use of commodities and encourage their replacement by cheaper alternatives. They also incentivise the exploitation of new or unconventional sources of supply, and encourage innovation in methods of production or extraction. Developments in all of these areas may also occur spontaneously without the spur of higher prices. Despite these qualifications, it seems fairly certain that the consumption of most commodities will continue to increase as world population and per capita incomes grow. What happens to commodity prices will depend on the evolution of supply. It is conceivable that supply-side developments, such as new sources of supply and methods of production, will make many commodities so plentiful that their real prices will fall on a permanent basis despite higher levels of output. A more plausible scenario is that real commodity prices will exhibit a gradual upward trend, punctuated perhaps by occasional large fluctuations.

## **5. Going Global: Will China (or India) Buy the World?**

The emergence of China as an economic giant, a formidable competitor with a voracious appetite for oil and minerals, has caused widespread unease or even fear in the rest of the world.

Fear of Chinese economic prowess is nothing new. Many years ago the still popular left-wing children's writer, Jack London, wrote a short story called *The Unparalleled Invasion*<sup>17</sup>. This story describes a fictional world in which the Chinese out-compete other nations through hard work and intelligence, and how they threaten to dominate the world peacefully without the need for warfare. The story ends when the governments of other countries unite to exterminate the entire Chinese population by infecting them with the plague and other deadly viruses. Such fears have surfaced once again, although in less extreme form. A few years ago, it was the fear that low-wage imports from China would wipe out manufacturing industry in rich countries. Now it is the fear that the Chinese are using their supposedly vast financial wealth to buy up swathes of foreign business, and to monopolise the oil and mineral resources of African and other developing countries.

The above claims have been comprehensively rejected in a well-documented book by Peter Nolan<sup>18</sup>. He argues that the scale of overseas investment by Chinese firms is grossly exaggerated and that while some of these firms may have large operations at home, they are relatively small players on the world stage. This is true even in the case of natural resources, where Chinese overseas investment in oil and mineral extraction has given rise to claims of a new imperialism. A central theme of Nolan's book is that China is vulnerable. It is highly dependent on imported commodities, especially oil; and many of its overseas investments in natural resources are defensive in character and designed to ensure security of supply. Nolan points out that foreign multinationals have invested far more in China than Chinese firms have invested overseas. He also defends the role of the Chinese government in encouraging and supporting the recent outward thrust of state-owned firms because it is the only way to break into global markets which in many industries are currently dominated by a handful of established giants.

The evidence mostly supports Nolan's argument. In particular, despite recent developments, Chinese firms are still, for the most part, minor players on the world stage, although the situation may change if China continues on its planned trajectory. Let us review some of this

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<sup>17</sup> London (1910).

<sup>18</sup> Nolan (2012).

evidence. The following remarks mostly concern China, but we also make reference to India where appropriate.

<b>Table 1. Outward FDI Stocks of Mainland China , Hong Kong and India US billions</b>			
	2003	2010	Growth rate (% p.a.)
Mainland China	33.2	317.2	38.0
<i>of which to</i>			
Hong Kong	24.6	199.1	34.8
Rest of World	8.6	118.1	45.4
Hong Kong	414.6	1039.0	14.0
<i>of which to</i>			
Mainland China	146.4	426.8	16.5
Rest of World	268.1	582.7	11.7
<b>China (incl. HK) to Rest of World</b>	<b>276.7</b>	<b>700.8</b>	<b>14.2</b>
India	6.1	96.9	48.5
<i>For comparison:</i>			
USA	2729.1	4766.7	8.3

Source: China: Davies (2012); Hong Kong Government (2006, 2012); India, USA: UNCTAD database. The estimates for Hong Kong FDI are derived by converting the original figures from Hong Kong dollars into US dollars.

In 2000, the Chinese government announced its “go global” policy. One objective was to improve the operations of China’s large state owned enterprises (SOEs) by exposing them to the challenges and opportunities of global markets. Another was to secure future supplies of energy and raw materials<sup>19</sup>. Since then foreign direct investment (FDI) by Chinese firms has mushroomed and it is this development above all that has fed concerns about Chinese expansion<sup>20</sup>. There has also been a sharp upswing in outward FDI from Hong Kong and India. However, despite this recent growth, the stock of overseas investments held by these

<sup>19</sup> Davies (2010)

<sup>20</sup> Foreign Direct Investment (FDI) refers to an external investment whereby an investor who is resident (individual or organisation) in one economy acquires a lasting interest and a significant degree of influence or an effective voice in the management of an enterprise located in another economy. For statistical purposes, an effective voice is taken as being equivalent to holding 10% or more of the voting power of an enterprise. For a given economy, inward FDI refers to direct investment in this economy by foreign residents. Outward FDI refers to direct investment in the rest of the world by residents of the given economy.

economies is still relatively small. More than half of outward FDI stock of mainland China is located in Hong Kong and about 40 per cent of the Hong Kong outward FDI stock is located in mainland China (Table 1). When such cross-holdings are eliminated, the result is a total of \$US700.8 billion for the FDI stock held by China (incl. Hong Kong) in the rest of the world in 2010. In the same year, the American direct investment abroad was valued at \$4766.7 billion which is almost 7 times the Chinese total and 49 times the Indian total. To put the Chinese figure into perspective, it is less than one third of Italy's national debt.

There has been extensive, mostly negative, publicity in the Western media about Chinese investment in Africa. Yet despite its recent growth, China's investment stake in Africa is still small compared to that of Western countries. The same is true for India. In 2011, the stocks of Chinese and Indian foreign direct investment (FDI) in Africa were \$US 16 billion and \$14 billion respectively<sup>21</sup>. In the same year, the combined total for France, the USA and the UK exceeded \$US150 billion. The Heritage China Global Investment Tracker records Chinese investment projects abroad worth at least \$100 million each<sup>22</sup>. Because of their large size these are disproportionately concentrated in energy and mining. Of the 405 projects recorded over the period 2005-2012 a total of 45 were located in Africa, and the rest were scattered throughout the globe, including many in developed economies.

The above comparisons indicate how the stock of Chinese and Indian investments abroad is still relatively small. However, these investments are growing rapidly and their share in the world FDI stock is increasing. Between 2003 and 2010, the combined investments of mainland China and Hong Kong in the rest of the world grew at 14.2% p.a. (Table 1). For India and the USA the growth rates were 48.5% and 8.3% respectively. Under the improbable assumption that such growth rates were to continue unchanged into the future, India would overtake the USA in 2023 and for China (including Hong Kong) this would occur in 2047. The Indian projection is beyond the bounds of possibility, but it is conceivable that China as a whole may begin to rival the USA as an overseas investor by mid-century.

What actually happens in the future will depend on many factors. If China continues along its projected growth trajectory, the Chinese state-owned enterprises (SOEs) will continue their outward thrust. However, there may be resistance to this in foreign countries that fear a loss of autonomy if much of their industry or stock of natural resources falls under the control of Chinese SOEs or sovereign wealth funds. There have already been cases in Australia, the USA and elsewhere where Chinese SOEs or sovereign wealth funds have been discouraged from investing in local companies or setting up business on their own (see below). This may change if SOEs are privatised but so long as they remain under state control they may continue to be viewed with suspicion, and there will always be some suspicion of sovereign wealth funds. Moreover, if the Chinese economy falters, the pace of outward investment may also falter. In the case of India, the growth rate of investment abroad will depend on what happens to the India economy and on its ability to develop domestically controlled firms that are big enough to expand on a large scale abroad. During the present currency crisis the India government has imposed temporary exchange controls on most types of outward direct investment. This should, for the time being, reduce the pace of overseas expansion by Indian firms.

The overall picture can be summarised as follows. In line with the official "go global" policy, large Chinese firms are now rapidly expanding their overseas operations, and Indian firms are

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<sup>21</sup> UNCTAD (2013) pp.7-8.

<sup>22</sup> Heritage Foundation (2013)

following suit. Despite these developments, Chinese and Indian FDI is still a small fraction of world FDI, and Chinese and Indian multinationals account for a tiny fraction of economic activity in the developed economies. The situation will begin to change as Chinese and Indian firms continue their outward thrust, but it will be a long time before the scale of their overseas investments begins to rival that of the USA or Europe.

## 6. A New Imperialism in the Making?

Book titles like *When China Rules the World* by Martin Jacques imply that we are witnessing a new imperialism in the making<sup>23</sup>.

The term “imperialism” has many different meanings. In the *Dictionary of Human Geography*, it is defined as "an unequal human and territorial relationship, usually in the form of an empire, based on ideas of superiority and practices of dominance, and involving the extension of authority and control of one state or people over another"<sup>24</sup>. Other definitions have a more explicit economic dimension.

### *Rivalry*

In his classic work, *Imperialism, the Highest Stage of Capitalism*, Lenin identified imperialism as a special stage of capitalism “with the following five basic features: (1) the concentration of production and capital has developed to such a high stage that it has created monopolies which play a decisive role in economic life; (2) the merging of bank capital with industrial capital, and the creation, on the basis of this “finance capital”, of a financial oligarchy; (3) the export of capital as distinguished from the export of commodities acquires exceptional importance; (4) the formation of international monopolist capitalist associations which share the world among themselves, and (5) the territorial division of the whole world among the biggest capitalist powers is completed. Imperialism is capitalism at that stage of development at which the dominance of monopolies and finance capital is established; in which the export of capital has acquired pronounced importance; in which the division of the world among the international trusts has begun, in which the division of all territories of the globe among the biggest capitalist powers has been completed”<sup>25</sup>

The world has not evolved as Lenin expected. The old empires have collapsed, formal colonies have virtually disappeared, and the world is not neatly divided into spheres of influence; although there are still major inequalities of economic and military power. Some countries are still able to dominate others through economic means, and sometimes through the use of military force. The closest to an imperial power in the classic sense is the USA, which frequently uses its economic strength to influence or cajole foreign governments and on occasion seeks to impose its will by military force. However, with its current economic difficulties, and after a string of diplomatic or military setbacks in Afghanistan, Iraq, North Korea, Syria and elsewhere, and declining domestic support for war, America’s hegemony is clearly on the wane. No other capitalist country has anything like the capacity to qualify as an imperial power. It is certainly not the case, as Lenin claimed that “the division of all territories of the globe among the biggest capitalist powers has been completed”. However,

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<sup>23</sup> Jacques (2012)

<sup>24</sup> Gregory et al (2009) p. 373. The quotation in the text is taken from the Wikipedia entry on imperialism

<sup>25</sup> Lenin (1917).

some of his other predictions were accurate. Large swathes of the world economy are now dominated by giant global firms (“monopolies” in Lenin’s terminology) that operate in close collaboration with the big banks and compete fiercely with each other. And as he predicted, the export of capital as distinguished from the export of commodities has acquired exceptional importance.

Implicit in Lenin’s thinking was the idea that individual states in the leading capitalist states would support “their” firms in the global struggle. It has been argued that with the growing internationalisation of their activities today’s giant firms are losing their national identity. No matter where their headquarters are located, no matter what national label they bear they are all becoming very similar in terms of global spread and objectives<sup>26</sup>. There may something in this view. As the operations of large firms become more international, their interests are becoming less closely tied to the fate of their home economies. The giant food company Nestlé has its headquarters in Switzerland and is legally classified as a Swiss firm, yet only 2% of its sales and 3% of its employees are located in Switzerland, and its profits are largely unaffected by the performance of the Swiss economy<sup>27</sup>. However, this is an extreme example. Despite decades of globalisation, a substantial fraction, often a majority, of the operations of large American firms are still located in the USA. The same is true for Japanese firms. The picture is more complex in the case of European firms because their operations may be dispersed across several countries of the European Union. However, the Union as a whole still accounts for a substantial proportion of their operations and sales, and the fate of these firms depends to a significant extent on what happens to the European economy.

The top management of the large multinationals is certainly becoming more cosmopolitan and their R&D activities are often widely dispersed amongst many countries. But one should not exaggerate the scale of what has happened. Many multinationals, even when their production is mostly located overseas, still conduct a disproportionate share of their R&D in their home economy. Despite the fact that only a tiny fraction of its total production and sales are located in Switzerland, Nestlé still conducts 35% of its R&D in Switzerland.

Geoffrey Jones has challenged the notion that large multinational firms are becoming stateless global webs and that corporate nationality is increasingly irrelevant. Writing in the *Harvard Business Review*, he says: “Today, technological advances may permit different parts of the value chain to operate in different places, companies may hold portfolios of brands with different national heritages, and leaders, shareholders, and customers may be dispersed. Still, the nationality of a firm is rarely ambiguous. It usually has a major influence on corporate strategy, and it seems to be growing in political importance”<sup>28</sup>.

National governments and the EU Commission support “their” own firms in various ways. They lobby to gain better conditions for these firms in foreign markets, sometimes under the slogan of a “level playing field”. For example, the USA and the EU have been pressing for the reduction of inward investment restrictions in China and India so they can penetrate local markets more effectively. In the case of China they seek to protect the intellectual property rights of American and European firms.

How do China and India fit into all this? Large firms from both countries are starting to push outward and extend their external operations. However, as we have seen, this process is in its infancy, especially in the case of India which has hardly begun. Outward investors from

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<sup>26</sup> Rowthorn (1971). Nolan (2012), Reich (1991, 2013).

<sup>27</sup> Nestlé (2012)

<sup>28</sup> Jones (2006)

India are normally private firms and, as such, pose no particular conceptual problem. They are similar in terms of ownership structure and motivation to most existing multinationals. The situation is different in the case of China, where most outward FDI is undertaken by large state owned enterprises (SOEs). Chinese leaders are concerned to promote overseas investment by private firms but this has not so far happened on a large scale. The primary objectives of the SOEs are laid down by the government and the profit motive plays a smaller role in their decision-making than in the classic capitalist enterprise.

The close relationship between the large SOEs and the government has sometimes inhibited Chinese expansion abroad. A country may be reluctant to allow large parts of its economy to fall under the control of firms whose actions may be guided by the political imperatives of a foreign government<sup>29</sup>. There have been some high profile refusals. In 2005, the Chinese National Offshore Oil Corporation (CNOOC) made a \$US 18.6 billion cash offer to buy the American oil company UNOCAL, but this was abandoned after opposition in the US congress. In 2007, the Chinese company Huawei was prevented from taking over 3Com in collaboration with Bain capital, because of Huawei's alleged links with the People's Liberation Army<sup>30</sup>. One way to allay such fears is to reduce political control over the large SOEs and put their operations on a more transparent commercial basis, whilst retaining formal state ownership, perhaps with a minority private shareholding. This has been the practice so far. Full privatisation is a potential alternative. Many of the smaller SOEs have been privatised, but so far the large firms which dominate the "commanding heights" of the economy remain in public hands.

To the extent that the large SOEs become subordinate to market forces and driven by the profit motive, their behaviour will come increasingly to resemble that of capitalist enterprises, although their profits will accrue to the Chinese government rather than private owners. So long as these SOEs remain in public hands, the Chinese government will have a backstop control over them and will retain some ability to shape their global priorities. Even if some of the large SOEs were to be eventually privatised, so long as the major financial institutions remained in the public sector, the government would retain an indirect influence on the behaviour of former SOEs through its influence of the terms under which they can borrow. The entry of China and India will not alter fundamentally the nature of global rivalry between the large multinationals, although the fact that many of the large Chinese players are state-owned may alter the rules of the game somewhat. Moreover, as the external activities of the large state enterprises increase in importance, there will be increasing pressure to relax government control of their activities or even to privatise them. This is already happening anyway, but the going global policy may accelerate the move towards commercialisation and, ultimately, privatisation of the remaining state owned enterprises. The "commanding heights" of the Chinese economy are at present controlled by the government. It is an open question how far this will be compatible with continued global expansion of the large Chinese firms.

Is this imperialism? If by imperialism we merely mean the global rivalry of large firms which enjoy support from their "home" governments, then the present world system can be described as "imperialism" and China may be on the way to becoming an imperial power. This may also be true of India further down the track. However, the term "imperialism" in this context is unduly pejorative and is overloaded with outmoded symbolism. It is probably best to avoid it.

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<sup>29</sup> Drysdale and Findlay (2009)

<sup>30</sup> These examples are from Davies (2013).



## *The Scramble for Resources*

China's spectacular industrialisation has created a hunger for primary products, above all fuels and other minerals, many of which are imported from developing countries in Africa, Latin America and elsewhere. These countries are also valuable markets for Chinese exports. The growing engagement with China has been welcomed by many developing countries, if only because China provides a counterweight to the previously dominant Western powers. However, this engagement has its downside and some of the expected benefits have not materialised. In what follows, we shall focus mainly on China's relations with Africa, although there will be the occasional mention of its relations with Latin America. India's role as an importer of primary products will also receive some attention

Until recently, Africa's political élites have been enamoured with China. In return for access to the continent's natural resources, China has been willing to offer generous aid, cheap credit, expertise and manpower for infrastructural and other projects. In line with the Chinese policy of non-intervention in the internal affairs of other countries, such deals have come with few political strings attached, and are especially attractive to countries with poor records in terms of corruption or human rights. These generous and unconditional terms have allowed China to break into what was previously almost a European and American monopoly in Africa. However, there are signs of African discontent with the arrangement.

In an interview in the *Financial Times*, the governor of Nigeria's central bank, Lamido Sanusi, has warned that China is a "competitor as much as a partner ... capable of the same exploitative practices as the old colonial powers..."<sup>31</sup> Africa is "opening itself up to a new form of imperialism. China takes from us primary goods and sells us manufactured ones. This was also the essence of colonialism....China is a major contributor to the de-industrialisation of Africa and thus African underdevelopment."

Is the above picture of China's economic relations with Africa accurate? The answer is yes up to a point. A number of African countries now depend heavily on their exports of primary products, mainly oil and minerals, to China; and African producers of labour-intensive manufacture have been damaged by competition from Chinese exports. However, China is by no means the dominant player in Africa. China's direct investments in Africa have grown rapidly but are still modest in comparison to those of Europe and America; trade between Africa and China has also grown rapidly but most of Africa's exports, including oil and minerals, still go to non-Chinese destinations, such as Europe and the USA, and most of its imports come from these areas. Similar observations apply to China's economic relations with Latin America and Central Asia. With certain important exceptions, India's economic relations with developing countries does not compare in scale to that of China.

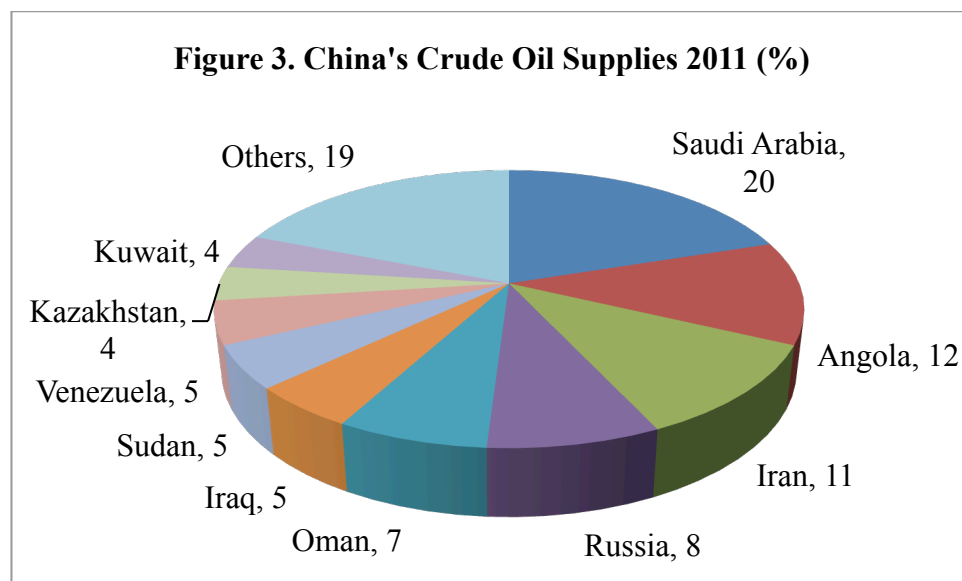
As mentioned previously, China and India's growing dependence on imported primary products makes them vulnerable to interruptions in supply. An objective of their external economic policy has been to reduce this vulnerability. Nowhere is this more evident than in the case of oil. According to a recent report to the US Congress, China has been involved in energy projects in more than 50 countries, spanning nearly every continent<sup>32</sup>. This investment in energy assets is driven to a large degree by its increasing dependence on imported energy

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<sup>31</sup> Wallace (2013)

<sup>32</sup>This paragraph draws heavily on Department of Defense (2013) pp. 19-20. .

and its suspicion of international energy markets. In 2011 approximately 58% of China's oil was imported and this figure is projected to rise to three quarters by 2030. In addition to ensuring reliable energy sources, China is diversifying transport options and energy producers. In 2011, 85% of China's oil imports came through South China Sea and the Straits of Malacca. It is seeking to reduce its dependence on sea lines of communication by building pipelines to Russia, Central Asia and the Middle East for oil and natural gas. Despite its diversification strategy almost 40 per cent of China's oil supplies still come from the Middle East and, with the exception of Angola, no single African country supplies more than 5 per cent of China's imports of crude oil (Figure 3). This suggests there is scope for further Chinese expansion in Africa.



Source: Department of Defense (2013)

In the case of India, it has been estimated that total energy consumption will rise by 141% between 2010 and 2040<sup>33</sup>. Much of this will have to be imported and to ensure adequate supplies it is government policy to encourage “investments in energy assets in foreign countries, especially for coal, oil and gas and uranium”<sup>34</sup>. In line with this objective, Indian state-owned oil companies are exempt from the emergency restrictions imposed on outward direct investment during the recent foreign exchange crisis<sup>35</sup>. The Indian government is keen to diversify its oil and gas supplies and to this end the state-owned Oil and Natural Gas Corporation has acquired shares in oil fields in countries like Sudan, Syria, Iran, and Nigeria. There are plans for a pipeline through Afghanistan that would bring natural gas to India and Pakistan from Turkmenistan. Another gas pipeline linking Iran to India via Pakistan is currently under construction.

Exports of fuels and minerals from Africa to China and India have grown exceptionally fast over the past decade or so (Table 2). As a result, the share of China in African exports of fuels and minerals has risen from 4.0% in 2000 to 14.1% in 2012. India's share has risen from 1.1% to 6.8% over the same period. Despite such growth China and India between them

<sup>33</sup> Exxon Mobil, p 49.

<sup>34</sup> Government of India (2012b) p.135.

<sup>35</sup> Mallet (2013.)

still account for less than a quarter of Africa's total exports of this type. The picture is similar for fuel and mineral exports from Latin America. Another important development in the case of Latin America is the growth of agricultural exports to China. These have risen from \$2.0 billion in 2000 to \$26.0 billion in 2012. Even so, China and India between them still account for only one sixth of agricultural exports from Latin America.

**Table 2 : Exports of Selected Products from Africa and Latin America 2000 and 2012, \$US billions**

	2000	2012	2000	2012	2000	2012
	Agricultural Products		Fuels & Mining Products		Manufactures	
Africa to:						
Africa	3.3	13.5	4.2	27.4	5.9	29.7
Latin America	0.2	1.5	3.3	25.8	0.5	2.9
China	0.4	3.1	3.4	61.7	0.2	2.1
India	0.5	1.5	1.0	29.8	0.8	2.6
Rest of world	13.9	37.7	74.9	293.1	28.5	66.2
World	18.3	57.4	86.8	437.7	35.8	103.4
Latin America to:						
Africa	1.6	14.8	0.3	1.9	0.8	4.1
Latin America	9.8	35.5	15.9	71.3	24.7	94.5
China	2.0	26.0	1.2	53.9	0.4	5.5
India	0.5	2.2	0.4	8.2	0.1	0.9
Rest of world	38.9	126.7	52.3	184.3	46.8	94.5
World	52.8	205.2	70.0	319.6	73.0	199.5

Source: WTO data base

### *Labour-intensive Manufacturing*

Labour-intensive manufacturing in Sub-Saharan Africa and elsewhere has been damaged by competition from China. Many local producers have been driven out of business by imports from China or by Chinese competition in third markets<sup>36</sup>. The Chinese combination of superior organisation and low wages has proved unstoppable.

The situation is worst in countries which rely heavily on the export of primary products. If a country starts to export primary products on a large scale, this will drive up the real exchange rate, making locally-produced manufactured goods more expensive in comparison to foreign

<sup>36</sup> See Hardy (2013) on Latin America, and Geda and Meske (2007) and Morrissey and Zgovu (2011) on Africa.

goods. Exports of such items will fall, imports will rise and the domestic manufacturing sector will shrink or fail to expand. This effect, which is known as the “Dutch disease”, has been observed in a number of countries in Africa and Latin America<sup>37</sup>. However, primary product exports to China and India are not the only culprit. As we have seen, despite the rapid growth of trade with China and India, most primary product exports from Africa and Latin America go to developed countries, such as Europe and the USA, or to other developing countries.

The domestic impact of revenue from primary product exports depends on how it is used. If it is invested wisely in areas such as health, education and infrastructure it will generate employment and provide the foundation for sustainable growth. It is also wise to invest some of this revenue in a sovereign wealth fund that can be used to smooth out the effect of fluctuations in commodity prices. All too often, however, especially in the case of oil and minerals, the export sector is an enclave which has few links to the rest of the economy and much of the revenue is siphoned off by a corrupt elite<sup>38</sup>. The danger is summarised in the following quotation from the African Development Bank<sup>39</sup>:

*The discovery of oil and minerals in a growing number of African countries is of enormous significance for Africa’s development. However, it may also have the effect of sharply increasing the level of corruption and the risk of conflict. In addition, natural resource booms can suppress growth in other parts of the economy – a phenomenon that is often referred to as “Dutch disease”.*

In its pursuit of oil and minerals, China and India have been willing to tolerate a high level of corruption in the countries they deal with. However, China and India are not the only culprits. Despite some improvements in recent years, corruption is still rife in much of Africa, including countries where Western oil companies have a dominant presence<sup>40</sup>.

The experience of African countries shows how rarely resource wealth is translated into self-sustaining and inclusive economic growth. Fuelled by income from natural resources, GDP in a number of African countries has grown rapidly but unemployment is rife and there has been little or no trickle down of income to the impoverished mass of the population. Report after report of the African Development Bank echoes this theme. All that varies is the name of the country.

It is this experience that informs Lamido Sanusi’s warning. However, the culprit is not simply China as he implies. Whilst China may supply many of the cheap labour-intensive manufactures that compete with African producers, the revenue which is used to purchase these imports often comes from primary product exports to non-Chinese destinations.

### *The Future of African Manufacturing*

China’s rapid development is creating new opportunities for African manufacturing. Wages in many African countries are now lower than in China, and Chinese firms are starting to

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<sup>37</sup> See Van der Ploeg and Venables (2013) for a general discussion of the Dutch disease.

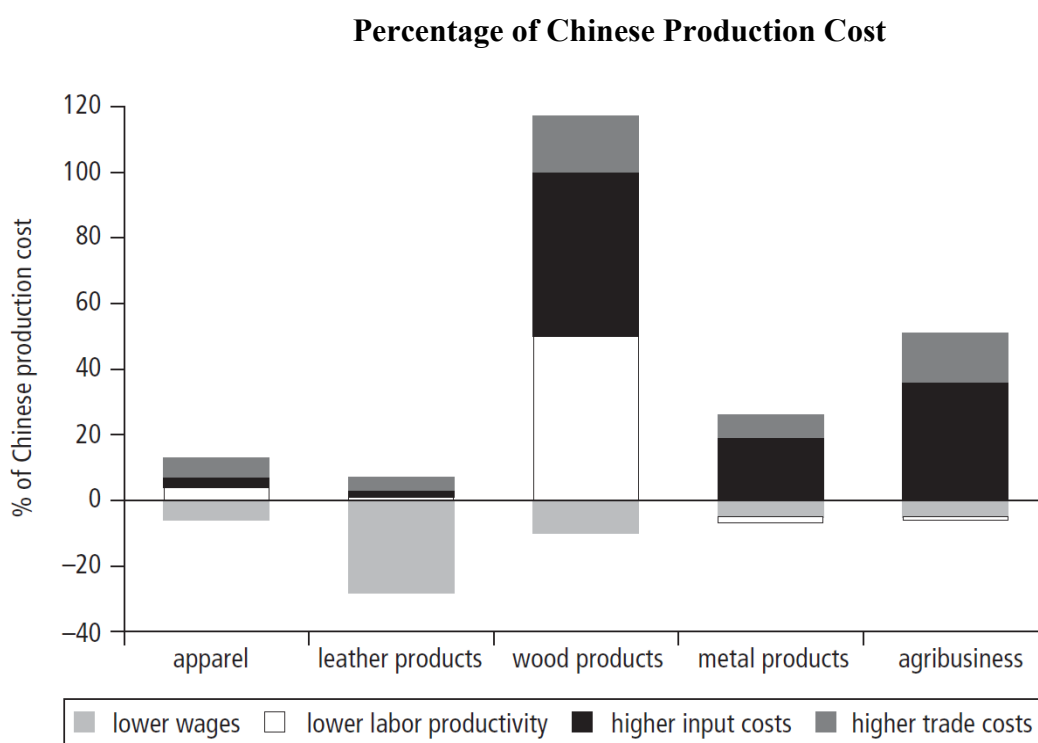
<sup>38</sup> See Carmody (2011).

<sup>39</sup> African Development Bank (2011), p. 20.

<sup>40</sup> Of the bottom 38 countries Transparency International’s 2012 Corruption Perceptions Index 16 are in Sub-Saharan Africa (Transparency International, 2012).

invest in labour-intensive manufacturing in Africa. However, this process is in its infancy and labour-intensive manufacturing is still virtually absent in many African countries. According to a recent World Bank report, employment in the apparel sector was 4,587,000 in China and 1,194,310 in Vietnam; the corresponding figures for African countries were Ethiopia 9,746, Tanzania 2,000 and Zambia 1,500<sup>41</sup>. There are still many obstacles to overcome before manufacturing takes off in Africa. There is a scarcity of well-serviced land with suitable transport links and utilities, local workers often lack the required skills, and suitable inputs

**Figure 4. Sources of Excess Production Costs of Medium Firms in Africa: Average across Ethiopia, Tanzania, and Zambia**



Source: Dinh et al (2012), p. 55

may be hard to obtain or expensive. When these factors are taken into account, despite lower wages, Africa is often a more expensive place to produce than China (Figure 4). If such difficulties can be overcome, Africa may attract much of the labour-intensive manufacturing that will migrate in the future from China to other countries.

If Africa does eventually stop importing labour-intensive manufactures from China, this does not mean that it will stop importing Chinese manufactured goods altogether. It may simply be that manufactured imports from China will become more sophisticated. For the foreseeable future, Africa will continue to export oil and minerals to China and it will continue to import manufactures of some kind from China. This is not an intrinsically exploitative relationship. Provided African economies can utilise their revenue from oil and mineral exports to develop other sectors of their economy including domestic manufacturing, the exchange with China will be of mutual benefit. So far this revenue has often been misused, but this is not

<sup>41</sup> World Bank (2011), p 77.

inevitable. There are several examples, such as Canada, that export natural resources in return for manufactured imports, but also maintain a vibrant domestic manufacturing sector.

## 7. The Military Balance

The emergence of China, and further down the line India, as great economic powers is provoking a shift in the military balance in the Asia-Pacific region. Concern about China's increasing strength and assertiveness is leading many countries in the region to upgrade their own military capabilities and to forge new alliances or strengthen old ones. In the case of Japan, Prime Minister Abe is seeking to revise article 9 of the Constitution which forbids the use of **force** as a means for settling international disputes and limits Japan's ability to expand its armed forces. Total military expenditure in Asia will soon surpass that of the European Union and Russia combined<sup>42</sup>.

China's military strategy was outlined as follows by President Hu Jintao's in his report at 18th Party Congress<sup>43</sup>:

*“Building strong national defence and powerful armed forces that are commensurate with China's international standing and meet the needs of its security and development interests is a strategic task of China's modernization drive.....”*

*“We should make active planning for the use of military forces in peacetime, expand and intensify military preparedness, and enhance the capability to accomplish a wide range of military tasks, the most important of which is to win local war in an information age....”*

*China pursues a national defence policy that is defensive in nature. Our endeavours to strengthen national defence aim to safeguard China's sovereignty, security and territorial integrity and ensure its peaceful development. China's armed forces have always been a staunch force upholding world peace and will continue to increase cooperation and mutual trust with the armed forces of other countries, participate in regional and international security affairs, and thus play an active role in international political and security fields.*

The above statement of strategic objectives ignores the fact that there is no universal agreement about what constitutes Chinese territory or about China's maritime rights. China has settled its former border disputes with Pakistan and Russia, but points of conflict with other countries remain. There are unresolved territorial disputes with India, which have already given rise to one major war between the two countries and are still the cause of frequent skirmishes between their armed forces. There are also on-going disputes with most of China's Pacific neighbours. What China regards as legitimate defence of its territorial integrity is seen by many of its neighbours as territorial aggrandisement.

Much of the friction between China and its Pacific neighbours is concerned with disputed islands, and related fishing or undersea mineral rights. This helps to explain why the regional

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<sup>42</sup> Comparison based on data from the SIPRI (Stockholm International Peace Research Institute) database.

<sup>43</sup> [http://news.xinhuanet.com/english/special/18cpcnc/2012-11/17/c\\_131981259\\_11.htm](http://news.xinhuanet.com/english/special/18cpcnc/2012-11/17/c_131981259_11.htm)

arms race has an important naval dimension. China and India are both investing in new aircraft carriers; Japan has just launched a new destroyer with carrier-like features; China, India, Malaysia, Singapore, Vietnam, Indonesia, South Korea, Australia, Japan and Pakistan are all expanding their existing submarine fleets or creating new ones; and in the case of China and India, some of their new submarines are nuclear powered and will be equipped with nuclear missiles. There is also expansion and upgrading in other military domains such as land-based missiles, aircraft, surveillance, advanced command and control systems and cyberspace. China's upgrading programme lays particular emphasis on electronic warfare which is seen as of equal importance to traditional ground, sea and air forces<sup>44</sup>. Through the use of electronic warfare the Chinese military hope to reduce or eliminate U.S. technological advantage in other domains.

The United States is currently the strongest military power in the world by a long way. Its military capacity, except in terms of manpower, greatly exceeds that of any country in the Asia Pacific region, not just in crude numbers (see Table 3) but also in the sophistication of its equipment. However, the balance is shifting. The International Institute of Strategic Studies projects that in terms of military expenditure China will overtake the United States at some time between 2025 and 2050<sup>45</sup>. Uncertainty about the timing of this event derives from uncertainty about future economic growth rates and about the shares of GDP that the two countries will in future commit to military expenditure. India is a long way behind but it is also upgrading its armed forces. Over the decade, 2002-2012, annual military expenditure by China increased by almost 200 per cent. For India the figure was 68 per cent<sup>46</sup>.

One constraint on India's military expansion is its high dependence on imports of high-tech weapons, mostly from Russia. Whereas China has a strong and increasingly sophisticated indigenous defence industry, the Indian defence industry is inefficient and produces mostly low-tech weapons. India is currently spending twice as much on imported weapons as China and such imports account for 65 per cent of its total expenditure on military equipment<sup>47</sup>. As India develops economically, this dependence will presumably decline.

In response to China's growing military prowess and the potential for regional conflict the United States has announced a rebalancing of its strategic priorities with greater emphasis on the Asia-Pacific region. China has one great advantage in this context. The United States still sees itself as a global power which, despite its new priorities, cannot afford to divert too many of its military resources to the Asia-Pacific region. In contrast, China's military objectives are, for the time being at least, mainly confined to its geographical periphery where it can concentrate its armed forces<sup>48</sup>. Faced with this reality, the United States is hoping to share the military burden with China's regional neighbours. Indeed, this is already happening. In 2012, the combined military expenditures of the ASEAN countries plus Japan, South Korea and Taiwan amounted to \$135 billion which is not far short of China's military

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<sup>44</sup> Department of Defense (2013), p. 37

<sup>45</sup> IISS(2013), p. 256

<sup>46</sup> The figures for China and India are from the SIPRI (Stockholm International Peace Research Institute) database. Expenditure is measured at constant (2011) US dollars.

<sup>47</sup> IISS (2013)

<sup>48</sup> See Shambaugh (2013) chapter 7.

expenditure of \$166 billion.<sup>49</sup> The United States could in theory forge a formal alliance with China's Asia-Pacific neighbours similar to NATO in Europe. However, quite apart from the fact that many countries would refuse to join such an alliance, it is likely that such a policy would be seen by China as a threat to its security and would stoke up tension in the region.

**Table 3. Military Strength of Selected Countries in 2011/2012**

	Military expenditure US\$ billions	Number in armed forces (‘000)	Tanks	Aircraft	Aircraft carriers	Sub-Marines
USA	645.7	1520	8325	15293	10	71
China	102.4	2285	7950	5048	1	63
Russia	59.9	845	2867	4498	1	58
Japan	59.4	247	920	1252	0	16
India	38.5	1325	3555	1962	1	15
S. Korea	29.0	655	2466	871	0	14
Australia	25.1	57	59	377	0	6
Taiwan	10.3	290	2005	805	0	4
Singapore	9.7	73	132	359	0	6
Indonesia	7.7	396	400	444	0	2
Pakistan	5.9	642	3490	1531	0	8
Thailand	5.5	361	584	743	1	0
Malaysia	4.5	109	69	244	0	2
Vietnam	3.3	482	2860	644	0	0
Philippines	2.6	125	41	184	0	0
N. Korea	?	1190	5400	1667	0	70

Source: Expenditure and number in armed forces from IISS (2013).

Other items are from <http://www.globalfirepower.com/countries-listing.asp>

Countries are ranked according to their military expenditure in 2012

The strategic dilemmas facing the United States in its future relations with China have been recently analysed by James Dobbins, formerly American ambassador to the European

<sup>49</sup> Data from the SIPRI database.



Community and Assistant Secretary of State<sup>50</sup>. He identifies the causes most likely to occasion a China–US military clash over the next 30 years as follows: “changes in the status of North Korea and Taiwan, Sino-American confrontation in cyberspace, and disputes arising from China’s uneasy relationships with Japan and India.”<sup>51</sup> He goes on to argue that, although the United States still has the capacity to offer direct defence to China’s neighbours in the event of a conflict, this capacity will decline as China grows stronger. The United States will eventually be forced to rely on some alternative to direct defence. The aim would be to deter China by threatening some form of escalation, such as a first-strike nuclear attack or a comprehensive economic boycott. The analogy here is with the containment of the Soviet Union in Europe after World War Two. However, there is a problem with such threats. A nuclear first-strike on China would be suicidal for the United States since China could retaliate by using the second-strike force of land and submarine launched missiles that it is now developing. It is hard to believe that the United States would launch a nuclear strike if China were to occupy the Spratly islands, for example. A comprehensive trade war with China could also be damaging to the United States, although it might develop out of a tit for tat escalation.

On a more positive note, Dobbins argues that China is seeking neither territorial aggrandisement nor ideological sway over its neighbours, although he warns that:

*“A climate of mutual distrust and suspicion clouds the US–China relationship, producing a potent security dilemma. If ignored, this dynamic could spiral out of control. Altering it will require both the United States and China to fundamentally rethink their national security goals and strategic assumptions in Asia and beyond..... As China becomes a true peer competitor, it will also potentially become a stronger partner.....Even as the United States seeks over the next several decades to sustain its defence commitments and advance its interests in East Asia, it will also have an interest in encouraging the world’s other emerging superpower to assume greater responsibility for international peace and security. China’s efforts to combat piracy in the Indian Ocean, and its growing interest in United Nations peacekeeping, should become the basis for enhanced US–Chinese cooperation. In the long term, the United States will want to look for other ways to leverage Chinese power as well as restrain it”*<sup>52</sup>

There is also the question of failed states. Both Pakistan and North Korea are potentially unstable and either of them may collapse into disorder at some time in the future. If this happens the question will arise as to who controls their nuclear and other weapons of mass destruction, and there may be outside intervention to ensure that these weapons do not fall into the wrong hands. This in turn may lead to intervention by other powers. In the case of Pakistan, the first country to intervene would probably be India or the United States, but this might in turn provoke some form of action by China which can quickly mobilise powerful forces along its disputed border with India<sup>53</sup>. In the case of a collapse in North Korea, the initial intervention might come from South Korea and the United State, although China might well respond by sending in its own forces to prevent a complete take-over of the North by its rivals. In either case, the result of collapse might be a confrontation between the future great

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<sup>50</sup>Dobbins (2012).

<sup>51</sup> Dobbins ( 2012) pp. 7-8

<sup>52</sup> Dobbins (2012), p.22

<sup>53</sup> Nair (2013)

powers. This prospect makes it especially important to establish a working partnership between the great powers to deal with such contingencies in a co-operative fashion.

The theme of power-sharing is explored in depth by the Australian military analyst, Hugh White<sup>54</sup>. He proposes a new political settlement in which leadership in Asia would be shared between four great powers: China, India, the USA and Japan. These countries would negotiate agreed ground rules to regulate competition and cooperation between them. They would also establish a framework for the regulation of interstate relations involving other Asian countries. Japan appears as an independent power in this list because, in White's view, a rising China will become increasingly hostile to the present status of Japan as an American strategic client. Conversely, the USA would not tolerate the absorption of Japan into China's sphere of influence. White's vision involves the full-scale re-armament of Japan, including the proposal that Japan should acquire sufficient nuclear weapons to act as a minimal deterrent against a Chinese nuclear attack.<sup>55</sup>

It is conceivable that the USA will gradually scale back its military engagement in the Asia Pacific region, because it is too expensive to compete with China and the region is no longer seen as of vital national importance to America. A precedent for this would be the withdrawal of most British armed forces from "East of Suez" from the 1970s onwards, partly on grounds of expense and partly because British interests in Asia were no longer deemed sufficient to justify a large military presence there. The gap left by the departure of the USA might open the way for China to become a hegemon in the Asia-Pacific region to which other countries in the region must defer. Even if the USA remains a major military power in the Asia Pacific region, China will have a growing influence over its neighbours, if only because of the enormous size of its future economy and its ability to confer economic costs and benefits on these neighbours.

## **8. Concluding Remarks**

Despite its large GDP and its newly acquired status as the world's leading exporter of goods and services, China is still what David Shambaugh calls a "partial power"<sup>56</sup>. It has few truly global companies and the overseas operations of Chinese firms are still small in comparison with those from the advanced economies. In military terms it is no match for the United States on a global level, although it is a strong regional power in its immediate vicinity. If China continues on its projected trajectory, Chinese firms will continue their outward expansion and the Chinese military will acquire the capacity to act effectively on a global scale. China will then become a truly global power. The same observations apply to India, although there is more uncertainty about its future growth prospects. Even if it does return to its projected growth path, India will take much longer than China to become a global power.

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<sup>54</sup> White (2013)

<sup>55</sup> White (2013), pp. 84-5

<sup>56</sup> Shambaugh (2013)

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