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## *From the Editors' desk*

When Ezra Vogel's *Japan as Number One* hit bookshelves in 1980, the Japanese economy (in PPP terms) was a third the size of the United States'. Despite being a US ally, the decade was punctuated by trans-Pacific trade and other frictions. Japan was viewed by some as an economic threat, and was strategically derided for 'free riding' on the United States' security order.

Dealing with China today, these concerns seem quaint. China's GDP reached a third of US levels in 1998, and now exceeds it in PPP terms. And strategists are probably nostalgic for a rising power that chooses to free ride on an existing order rather than change it.

China's economic footprint alone means that, ready or not, all countries in the world have to manage its impact.

The first step is an understanding of the Chinese economy today (to which He Fan, Paul Hubbard and Jane Golley contribute in this edition of *EAFQ*). This means realising that China itself is not as developed as Japan was by 1980, then already a high-income country. China faces the myriad development problems of middle-income countries everywhere, from its undeveloped financial system, its winding path to rule of law and its myriad environmental challenges (Yiping Huang, Hu Shuli and ZhongXiang Zhang).

China's sheer size means that the inevitable shocks and policy missteps it generates will affect its economic partners. Managing these spill-overs will be much easier for China if it can maintain peace in Southeast Asia, construct its new relationship with India, and expand opportunities beyond in Eurasia (issues addressed by Zhang Yunling, Kishore Mahbubani and David Brewster).

Bilateral, multilateral (discussed by Theodore Moran, Peter Drysdale and Zhang Xiaoqiang), and grass-roots (discussed by Peter Cai) approaches can assist in managing the China relationship too.

This issue's Asian Review looks at the transnational threats of extremism and organised crime (Greg Fealy and Roderic Broadhurst), as well as the politics of disillusionment in the West that makes tackling big issues like these so much harder (Hugh Mackay).

***Paul Hubbard and He Fan***

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COVER: Lights burn late in Shanghai's Pudong financial district. More efficient financial markets will be instrumental in China's continuing rise. PICTURE: CARLOS BARRIA / REUTERS.

PICTURE: TYRONE SIU / REUTERS

Theatrical zombies like this performer in Hong Kong vanish after Halloween, but zombie companies just hang around, holding back China's economy.

# Dealing with zombie enterprises

HE FAN

AS Warren Buffett said, when the tide goes out, you can see who's been swimming naked. As China's growth slows, an army of zombie enterprises has emerged. These zombie companies are heavily indebted, kept afloat only by continuous support from government and banks. The government does not want to see zombie companies wiped out because it worries about the messy results—rampant unemployment and a significant loss of tax revenue. The banks are willing to lend a hand because they do not want to see their earnings fall when forced to make provisions to bad debts.

Both the government and the banks try to help these companies in the hope there will be a market rebound soon. Unfortunately, zombie enterprises are holding back economic recovery in China. Their existence prevents resources from being reallocated to more productive industries, resulting in an uneven playing field.

Senior leaders in China have pledged to phase out poor-performing zombie enterprises. Closing companies with overcapacity is a priority of the government's 'supply-side reform' strategy. But what do zombie enterprises look like in

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China, and who are they?

Zombie enterprises are those that are losing money but can borrow at a price below the market rate. The more they lose, the more they can borrow—that's the only way they can survive. Our recent research on China's listed companies suggests that roughly 10 per cent of listed companies in China are among the walking dead. This is likely an underestimate, given requirements for listing.

Zombie enterprises are floating with the ups and downs of China's growth. After the global financial crisis, the number of zombie enterprises increased sharply. But the RMB4 trillion (US$590 billion) stimulus policy the Chinese government adopted in late 2008 gave these enterprises breathing space. The number of zombie enterprises dropped briefly, and then rose again as China's growth slowed. The zombie company problem has become much harder to ignore.

Zombie enterprises are clustered in industries burdened by debt and overcapacity, like iron, steel, aluminium and cement. These industries had investment booms that left behind too many factories and too little demand.

Although the real estate sector does not have the highest ratio of zombie enterprises, it makes up a large share of Chinese listed companies. Because so many apartments were built during the boom, developers have a difficult time reducing their inventory. State-owned enterprises (SOEs) have a higher propensity to turn into zombie enterprises—a private enterprise, after several years of losses, has no way to continue and has to shut down. SOEs, however, can keep getting fresh credit from the banks.

Drawing a line from China's northeast to the southwest, one

Zombie enterprises are those that are losing money but can borrow at a price below the market rate. The more they lose, the more they can borrow

can find the new rust belt. Zombie industries are not located in the most advanced coastal areas nor the least developed Western backwaters, but in the middle—Heilongjiang and Liaoning in the northeast, Shanxi in the Loess Plateau, Hebei in the North China Plain and Hunan in the Yangtze Basin. They are either resource-rich or smokestack-heavy industrial bases. These less economically diverse areas are the most vulnerable to declining growth rates and commodity prices.

The greatest obstacle to shutting down or scaling back the zombie enterprises is unemployment pressure. Forcing zombie enterprises into bankruptcy will leave millions jobless. The government fears that mass layoffs could lead to social instability. The leadership has announced the establishment of a fund of RMB100 billion (approximately $US15 billion) to assist the newly jobless. But is it enough?

In a recent paper we look at six industries that have serious overcapacity problems: steel, coal, cement, glass, papermaking and non-ferrous metal. We assume that the capacity utilisation rate should be adjusted to 80 per cent, a reasonable level by international standards. We assume that if capacity needs to be downscaled by, say, 10 per cent, the workers employed in that sector will also be cut back by the same ratio.

Under these assumptions there would be around 4.31 million redundant: 950,000 in steel, 1.22 million in coal, 440,000 in papermaking, 1.38 million in cement and glass together, and 320,000 in nonferrous metal. The cost of helping the unemployed would be between RMB163.75 billion and RMB491.25 billion (US$24–73 billion), depending on how generous the government chose to be.

Since the global financial crisis, leverage ratios of other major economies have been reduced, while the leverage ratio in China increased sharply. In 2009, debts owned by the Chinese government, households, the financial sector and the non-financial sector amounted to 49 per cent, 24 per cent, 15 per cent and 99 per cent of GDP respectively. By the end of 2015, these ratios had increased to 57 per cent, 40 per cent, 21 per cent and 131 per cent. The corporate sector's leverage ratio is especially high compared with other economies.

The government is currently trying to combine deleveraging with overcapacity reductions. One new plan is to allow commercial banks to swap the debt they hold in underperforming companies for stock holdings. These so-called 'debt-for-equity swaps' were used in China in the late 1990s, when the government transferred the bad debts of state-owned banks to newly established asset management companies. Whether this approach will help is open to debate.

A worker leaves the plant after sealing the doors of a cement factory in northern China. Cement is among the industry sectors  with serious overcapacity problems.

PICTURE: DAVID GRAY / REUTERS

The maximum amount of debt that one company can borrow should be no higher than its debt-servicing obligations. If the aim of debt-for-equity swaps is to alleviate the debt problem for firms, then more attention needs to be paid to reducing the debt of companies so they can operate in safe territory. The industries that need the most help are steel and coal, where real debt is already RMB3.86 trillion (US$570 billion) higher than this maximum debt size.

According to a recent Reuters analysis, profits of roughly a quarter of Chinese companies were too low in the first half of this year to cover their debt-servicing obligations. Earnings are languishing while loan burdens are increasing.

Companies may use debt-for-equity swaps to overcome temporary repayment issues, but the repayment issues will not easily disappear. Even worse, if banks cannot gain true ownership over indebted firms, the stress will be transferred from companies to banks.

The cost of closing or downsizing zombie enterprises may be higher than expected. Facing uncertainties, the government is still hesitating to swallow the bitter pill of factory closures and employee layoffs. Merging ailing companies will only create more giant zombies, and debt-for-equity swaps may swap zombie enterprises for zombie banks. But there is no solution without pain and cost. Now is the time to take the right medicine and start feeling the pain before it becomes unbearable. EAFQ

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PICTURE: KIM KYUNG-HOON / REUTERS

# Fragmented authoritarianism and state ownership

The Chinese national flag flies outside a commercial bank in Beijing's financial district.

PAUL HUBBARD

OVER the past 40 years a truly dynamic private sector has emerged from nothing and now dominates the Chinese 'world factory' of manufacturing exports. But while the Third Plenum of the 18th Party Congress in 2013 declared the market to play a 'decisive role' in the economy, it also reasserted the 'dominant position of public ownership'.

The most visible manifestation of China's public ownership is its state-owned enterprises (SOEs). At home they dominate key upstream sectors such as energy, resources, telecommunications, and banking. Abroad, they are the vanguard of Chinese overseas direct investment.

But given the oft-reported problems of China's state sector, is maintaining public ownership consistent with China's aspiration to become a high-income market economy? To answer this, we must be clear on what is meant by 'state', 'ownership' and 'enterprise'.

China's political system is often caricatured as a system of red telephones all ultimately connected to the desk of Chinese Communist Party General Secretary Xi Jinping. But while the general secretary is a powerful man, a more accurate description of China's political governance is 'fragmented authoritarianism'. Power and responsibility are delegated downward to provincial and local levels of government, as well as horizontally between state ministries with different, often competing functional responsibilities.

On paper, SOEs are owned by 'the people as a whole', but in practice each of the more than 100,000 SOEs is under the administration of a particular body within this matrix. Some 104 of the most important SOEs are under the administration of the State Council's State Asset Supervision and Administration Commission (SASAC). This body is responsible for China's flagship projects as well as its key infrastructure and defence industries.

There are also 900 other 'central' SOEs that report to the Ministry of Finance via other state and party agencies and ministries, including China's biggest banks. Profits from these central SOEs contributed 8 per cent of the central government's 2015 budget, of which the lion's share came from finance.

Thousands more SOEs are under the practical control of provincial and even county-level governments. These SOEs report through provincial and sub-provincial SASACs and finance bureaus rather than the central finance ministries. The huge variance in local interpretation and implementation of central government directives creates a greatly fragmented SOE model. For instance, cash-strapped provinces such as Liaoning take SOE reform as something along the lines of privatisation, while financial services frontrunners such as Shanghai interpret it as creating state capital management.

When we consider the notion of ownership, for an SOE this can mean giving some owners the right over an enterprise's financial profits, others the right to appoint or supervise management, and others the right to approve certain domestic or overseas investments. How these rights are distributed affects the incentives and therefore the behaviour of SOEs. The creation of SASAC in 2003 was partly motivated by a desire to consolidate previously dispersed rights to decide employment, investment and other key decisions into a single decision-maker that could be held accountable.

Even this consolidation of rights is incomplete—the right to appoint the top leadership of China's most important SOEs rests not with SASAC but with the party's Organization Department, while revenues ultimately flow through the Ministry of Finance.

In other cases, agents of the state actually give up some rights in order to achieve access to outside capital, technology and even supervision. For example, publicly listing SOE subsidiaries not just on stock markets within China, but on international markets in Hong Kong, New York and London introduces new transparency issues and outside constraints. So it should not be surprising that the boss of a minority-state-owned subsidiary of a provincial SOE might think and behave quite differently from the head of a central Chinese oil SOE whose next career move may be into the Politburo.

The final fragmentation relates to the role of the enterprise itself, in particular the relationship between business and the party. According to its constitution, the party's role in a public company extends to participating in major final decisions. In private business, the party has a narrower role to provide guidance in observing state laws and regulations. But in both cases the existence of party cadres and party discipline within ostensibly independent economic entities muddies any clear distinction between politics and business.

Chinese SOEs are not unique in terms of their relation to the state. In any environment that gives officials or politicians discretion to create rents, adjust regulations or spend money, even private companies have a strong incentive to develop close relationships and networks with current and prospective government officials. Consequently, while non-state companies in China lack formal ownership links to the state, any large and successful private or foreign firm needs to keep the state and party on side.

There is no simple 'ownership reform' that would cure China's economic maladies

What are the implications of this fragmentation for China's economy?

There is no such thing as a representative 'state-owned enterprise', and there is no simple 'ownership reform' that would cure China's economic maladies. While state ownership creates a conflict of interest between the state as owner and the state as regulator, turning lazy state monopolies into private profit-seeking monopolies not only makes things worse for consumers but would also create a new force for political opposition to reform outside the current political structure. Converting all of China's SOEs into private owned-enterprises would be to shift from 'state capitalism' to 'crony capitalism'.

Milton Friedman, who advised post-Soviet governments to 'privatize, privatize, privatize', ultimately conceded that privatisation was not enough, and that 'rule of law is probably more basic than privatization'.

Fragmentation of ownership allows for practical privatisation by ensuring that the regulating agents of the state are politically superior to the owning agents. If pro-competition policies are applied to all market participants regardless of ownership, it is entirely possible to reconcile a large state share with an efficient market economy. The necessary condition for prosperity is not ownership but rather that state intervention proceeds according to transparent, prospective and generally applicable laws. EAFQ

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# Babies and growth: why less could mean more

JANE GOLLEY

ON 1 January 2016 the Chinese government formally abolished the one-child policy, replacing it with a two-child policy. The dominant reason for this change, as stressed in Chinese media reports at the time, was that relaxing family planning policy would provide part of the solution to China's ageing problem. Higher fertility is expected to produce more than 30 million additional people in the labour force by 2050. The National Health and Family Planning Commission reported that a two-child policy could increase the rate of GDP growth by 0.5 percentage points through its impact on aged dependency—the ratio of people over 65 to those of 'working age', usually defined as between 15 and 64.

These calculations hinge on the assumption that a significant number of the fertile population will respond by actually having a second child—an assumption that is highly uncertain according to a string of demographic research on the topic. This research suggests an alternative future in which China falls into a 'low-fertility trap', consistent with other countries in the region, including Japan and South Korea. The question is: would such a trap really be a bad thing?

There is no doubt that China is confronting relatively rapid ageing of its population. Projections based on the UN's high- and low-fertility scenarios further illustrate that the potential higher fertility from the two-child policy will only have a minimal effect on reducing aged dependency by 2050. This effect is more than offset by higher youth dependency, ensuring that total dependency would be higher, not lower, even under the high-fertility scenario.

My ongoing research with Rod Tyers from the University of Western Australia takes this point further. We demonstrate that China's demographic dividend—the gains to per capita income from a rising share of workers in the total population—may not be a thing of the past. We stress that the use of age-based proxies for understanding the links between demographic change and economic growth is misleading because it fails to take into account the number of actual workers in the population, as opposed to those of 'working age'.

Our more carefully calculated dependency ratios provide at least one piece of good news for China. In contrast with alarming ageing trends shown in the UN research and elsewhere, total dependency measured more accurately may fall well into the future, under both high- and low-fertility assumptions.

> Beyond age structure, changes in fertility have implications for the skill composition of the labour force

Our most recent paper with Yixiao Zhou of Curtin University uses a dynamic global model to project through to 2050. The results show that fertility levels rising towards population sustainability levels would contribute to higher rates of GDP growth, a rise in the proportion of children and a reduction in the proportion of aged people in China in the decades ahead. It would also provide a modest source of higher domestic consumption, since children consume but don't save.

Still, these impacts would be small—less than half a per cent per year of GDP growth and a reduction in aged dependency of 0.03 percentage points. And these small benefits would come at a significant cost in terms of per capita GDP, reducing its level by 21 per cent in 2050 compared with the low-fertility alternative.

Beyond age structure, changes in fertility have implications for the skill composition of the labour force. A more skilled labour force raises the marginal product of capital—the extra output produced when one additional unit of capital is added. This boosts the level of investment, as well as affecting relative prices and competitiveness in different sectors of the economy.

In China, this skill composition is predominantly shaped by the proportions of the (relatively unskilled) rural and urban populations. In the first three decades of reform, the

PICTURE: JASON LEE / REUTERS

A man teaches his 10-month-old granddaughter her first steps at a residential community near Beijing. One official projection estimates that a two-child policy could increase the rate of China's GDP growth by 0.5 percentage points through its impact on aged dependency.

rural population experienced faster fertility decline from higher initial levels, compared with the trend in urban areas. This occurred despite the relaxation of the one-child policy in most rural areas to allow a second child if the first was female. This ensured that the bulk of China's demographic dividend stemmed from a surge in the rural working to non-working population ratio.

Conversely, if the rural population started having more children, real unskilled wage growth would slow down, due to an increase in the abundance of unskilled relative to skilled labour. This would sustain China's competitive edge in unskilled, labour-intensive manufacturing, but it would prolong its journey towards becoming a developed economy based on high-end industrial and service output. Per capita income would fall in the process. This point holds broadly for higher fertility among the urban population as well.

These results do not mean that one shouldn't support the Chinese government's decision to abolish the one-child policy. The non-economic benefits of this shift are likely to be, quite simply, immeasurable. Instead, they call for recognition that a two-child policy is not the first-best policy option for tackling either China's growth slowdown or its ageing problem.

Policies directed at increasing labour productivity and labour force participation rates would directly tackle the ageing problem and provide additional sources of growth as well. These include the recent extension of retirement ages to 60 years for women and 65 years for men, as well as more complex reforms to the education, welfare and *hukou* (household registration) systems. Combined with low fertility, such measures would increase China's chances of rising above middle-income status: a far more serious trap, with no obvious benefits to anyone. EAFQ

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# Market discipline the next step towards efficiency

YIPING HUANG
AND XU WANG

WHEN China embarked on economic reform at the end of 1978, the nation had only one financial institution—the People's Bank of China.

The decision by China's leaders to shift their policy focus from class struggle to economic development created an urgent need for a comprehensive financial system. Growing economic activities, especially those outside the state sector, required effective financial intermediation.

China's experience of financial reform has followed a unique path. While strong on establishing institutions and driving asset growth, it has been weak in liberalising markets and improving governance. But why has China followed this unique path? And what are the key achievements and risks of this reform approach?

China's financial reform can be seen as part of a broader 'dual-track' economic strategy. At the beginning of the reform period, the government adopted a dual-track reform approach between state and the non-state sectors. To support the relatively less efficient state-owned enterprises (SOEs), the government intervened in the pricing of production inputs. This led to a second dual-track approach, between product and factor markets. Similarly, repressive financial policies resulted in dual-track financial markets, split between formal and informal sectors.

Under the dual-track approach, SOEs' share in total industrial output began to decline, from around 80 per cent in the late 1970s to around 20 per cent in the mid-2010s. Despite various reform efforts in the 1980s, the state sector's financial performance deteriorated steadily. In the mid-1990s, China's SOEs made a net loss.

To staunch the SOEs' bleeding, the government had to adopt a dramatic reform program known as 'grasping the big and letting go of the small and medium' in September 1995. The objective was to focus only on very large SOEs in strategic industries and to release the rest. In the following three years, about 30 million workers lost their jobs and more than half a million SOEs disappeared.

Since SOEs continued to operate in increasingly open and competitive markets, they needed special supports to be able to survive. But financial policies that tried to protect SOEs discriminated against non-SOEs. As a result, and despite China's very large financial markets, an undersupply of financial services is still common in the formal sector.

> China's long march towards an efficient financial system is still only halfway to completion

Gradually, an informal sector emerged. The two sectors co-exist, with the formal sector mainly serving large companies and wealthy households and the informal sector mainly serving low-income households, and small- and medium-sized enterprises. While prices in the formal sector are often highly distorted, the informal sector is relatively market-driven.

While dual-track systems have created numerous forms of inefficiency and risk, they have not prevented the economy from growing rapidly in the past. One important question to ask is whether China engineered its economic miracle because of, or despite, its repressive financial policies.

In the early stages of economic development, financial markets are often underdeveloped and might not be able to effectively channel savings into the right investments. Financial institutions are often vulnerable to instability and fluctuations in capital flows. Under these circumstances, repressive financial policies can actually have a positive effect on economic growth.

In the 2000s, unlike previous decades, financial repression had a negative impact on economic growth. This reflects the view that state intervention in capital allocation can prevent funds from flowing to their most efficient uses. In this environment, repressive policies eventually hinder financial development, increase risks, reduce investment efficiency and hold back

PICTURE: JOHN RUWITCHI / REUTERS

A mascot of Ant Financial at the digital finance firm's office in Hangzhou. Digital finance serves groups of customers that have been neglected by the traditional finance industry.

economic growth.

The emergence of digital finance in China is a response to the undersupply of financial services caused by financial repression. Not only does digital finance serve groups of customers that have long been neglected by the traditional financial industry—by forming a parallel market, it is also a means of back-door liberalisation, where interest rates and fund allocation are determined by the market. The average peer-to-peer (P2P) investment rate now settles at around 10 per cent, compared with 3 per cent in the Shanghai Interbank Market.

At the same time, digital finance brings with it significant risks. In early 2016, of about 4000 P2P platforms, more than one-third were 'problem platforms'. This means that they have either discontinued operations or have encountered liquidity difficulties, embezzlement by management or some other form of financial crime. It is clear that digital finance needs to be properly regulated in order to play a more important role in China's financial system.

After nearly 40 years of economic reform, China's long march towards an efficient financial system is still only halfway to completion. Although it now has a comprehensive financial sector with many financial institutions and gigantic volumes of financial assets, market discipline is not enforced effectively.

Many international observers worry about imminent financial crises, given recent rapid increases in both non-performing loan and corporate leverage ratios. But the probability of an outright crisis remains low. The government's still-healthy balance sheet could buy some time for balance sheet adjustments in state-owned commercial banks and enterprises.

The greatest economic risk for China is growth stagnation. To avoid this, China needs to keep pushing ahead with financial reform.

In November 2013, Chinese leaders unveiled a program of comprehensive reform. The policies fell into three broad categories: creating a level playing field, freeing up market mechanisms and improving regulation.

Levelling the playing field means allowing private banks to flourish and fostering the development of inclusive finance. While it was justifiable for political and economic reasons to protect SOEs in the initial stages of reform, this policy is no longer an optimal choice.

Free markets are an inherent part of an efficient financial system. If the government wishes to continue to support SOEs, it should do so by using fiscal resources instead of manipulating and distorting financial markets.

Prudent regulation is also vital. Liberalisation can at times lead to market volatility and instability, well-illustrated by the experience of digital finance in China. While these services have added real value by filling an important gap in China's financial environment, they are also a source of new risks.

Such reforms are easier said than done. They are still subject to economic and political constraints and it is hard to predict how long it will be before these steps are taken. But these policies should help the government complete its mission of building an efficient financial system in China. They may well be the last steps in China's long march of financial reform.

EAFQ

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# Strong property rights for a stronger economy

HU SHULI

CHINA'S notoriously weak protection of private property rights is finally showing signs of improvement. And necessarily so, as the nation's ongoing economic transformation—as well as its commitment to long-term stability and prosperity—now hinges on upholding the rights of property owners.

In early September the Communist Party's Central Leading Group for Overall Reform, headed by President Xi Jinping, approved new property rights protection guidelines. The guidelines include 10 specific measures that underscore the party's interest in improving legal safeguards for the owners of tangible and intangible property. That includes commercial real estate, trademarks and intellectual property rights.

Every market economy is built on a foundation of property rights. Indeed, the modern world owes much of its prosperity to the tenets of property rights, along with the principles of freedom of contract and fair competition.

China has been pursuing better property rights protection since the late 1970s, chalking up some landmark achievements along the way. In 2004, for example, the constitution was amended to enshrine private property rights. And three years later, the first Property Law was promulgated.

Yet property rights are still often violated. Rules have sometimes failed to protect the assets of private entrepreneurs. In extreme cases, local government officials on asset-grabbing adventures have had private entrepreneurs kidnapped, attacked or even killed.

A few years ago, in the western Chinese city of Chongqing—at the time under since-disgraced regional party secretary Bo Xilai—false criminal charges were levelled against many private entrepreneurs before their assets were seized in the name of a 'crackdown on crime'.

Concerns about property rights violations help explain why an increasing number of private business owners are moving their assets overseas, throwing a spanner into China's economic transformation.

WHEN private assets, equity holdings and intellectual property rights are not protected, entrepreneurs can lose confidence in the business environment. A lack of confidence can discourage entrepreneurs from saving money and investing in innovation. Company executives may thus be more inclined to spend their money quickly rather than investing in research and development or planning for the future.

Government-led growth has been powering China for decades. Now there's an urgent need for a more efficient growth model that relies on innovation, new technology, industrial upgrading, service sector development and information systems. China's transformation has been complicated and difficult. It cannot now be pushed forward without fostering entrepreneurship.

The party's new guidelines have given that spirit of entrepreneurship a shot in the arm. The guidelines include a prediction that 'property rights protection will foster entrepreneurship and innovation'. Policymakers have thus confirmed the importance of strengthening property ownership as a foundation for a stronger economy.

THE guidelines also address some major concerns shared by private entrepreneurs. They point to a more tolerant attitude toward private businesses that have, in years gone by, built their wealth in ways that might have been illegal at the time. This new tolerance has eased anxiety among business owners who don't want to be penalised for committing 'original sins' during the early days of China's reform movement.

The guidelines also spell out legal procedures for criminal cases involving business assets. This means that accusations against a company or its executives are less likely to interrupt normal business operations. These procedures also provide a system for clearly dividing an entrepreneur's personal assets and a company's assets. There have been several cases in the past where an entrepreneur's individual assets were seized after false allegations were levelled against a company.

Under the guidelines, some controversial legal cases from the past involving property rights decisions are to be re-examined and unsettled disputes put to rest. Of course, it will be difficult to reverse and make amends for a previous conviction if, upon re-examination, an injustice is revealed. But righting wrongs is a must-do. Justice must be done and victims along with their families must be properly compensated.

There have been a number of cases where the verdicts have been re-examined and rectified in recent years, but information about these was kept under wraps. It is an encouraging sign that justice prevails. But the prevention of any publicity regarding these cases renders justice incomplete. Overturning a verdict is not enough. Making the results public should be part of efforts to compensate victims and hold guilty parties responsible.

Meanwhile, there are many cases of property rights violations that have been dragging on for years in some courts. These must be resolved without further delay.

Making amends for past property rights violations would go a long way towards improving the credibility of the nation's judicial system and promoting judicial reform. A fundamental reason for improving property rights protection is that doing so will advance the rule of law. Another is that it will pave the way for properly supervising those holding power.

China's policymakers have obviously taken a stand on property rights while arranging to better protect private property owners. Their latest guidelines will lead to reforms that change government functions while improving administrative efficiency. It's an enormously challenging task, but one worth every effort. EAFQ

*Hu Shuli is Chief Editor at Caixin Media.*

CLEAN AND GREEN

# Powering a low-carbon China

ZHONGXIANG ZHANG

SINCE launching its open door policy and economic reforms in late 1978, China has experienced spectacular economic growth and hundreds of millions of Chinese people have been raised out of poverty. But to achieve this, China has relied heavily on coal to fuel its rapidly growing economy.

Burning coal contributes to the overwhelming majority of China's sulphur dioxide, nitrogen oxide and carbon emissions. This has given rise to unprecedented levels of environmental pollution and health risks across the country, with dense smog and haze frequently shrouding Beijing and other areas. On top of this, global climate change is expected to pose additional threats to China.

Chinese leaders are well aware of these challenges. The country has given ecological goals the same level of priority as existing economic, political, cultural and social development policies and is making impressive progress towards implementing a low-carbon economic development framework.

China has moved away from centrally planned pricing towards more market-oriented mechanisms

Before the 2009 Copenhagen Climate Change Conference, China pledged to cut its carbon intensity by 40–45 per cent by 2020, relative to 2005 levels. Under the China–US climate statement in November 2014, China further strengthened its commitments, agreeing to cap its carbon emissions by 2030 and increase the share of non-fossil fuel use to 20 per cent.

These commitments were officially incorporated into China's Intended Nationally Determined Contributions submission to the United Nations in advance of the Paris climate summit. As a crucial step to meet the commitments, the Chinese government set an absolute limit for energy consumption at 5 billion tonnes of standard coal by 2020 and announced its aim to cut energy intensity by 15 per cent and carbon intensity by 18 per cent, relative to 2015 levels.

Given China's coal-dominated energy mix, abating carbon emissions is closely linked to reducing the state's energy consumption. While coal production appears to be slowing, the key challenge for China is to ensure that coal consumption peaks in the Thirteenth Five-Year Plan period from 2016–2020. On this trend of coal consumption, current estimates suggest that carbon emissions will peak between 2025 and 2030.

Capping coal consumption not only requires enhanced efforts in key energy sectors but also coordinated regional efforts. The Chinese government's Atmospheric Pollution Prevention Action Plan has set more stringent concentration targets for hazardous particles in the Beijing–Tianjin–Hebei region, the Yangtze River Delta and the Pearl River Delta. Given that many environmental issues are of a cross-border nature, neighbouring regions are increasingly acting collectively, which significantly increases the effectiveness of their efforts.

Renewable energy is another long-term solution to China's environmental worries and is one of seven strategic, emerging industries. China has fixed a target for alternative energy sources to meet 20 per cent of its energy requirements by 2030. Renewable energy can also help both to lower the level of peak emissions and move the peak forward.

While China has committed to cap its absolute greenhouse gas emissions by 2030, the level at which they will peak remains unknown. This is the 'make or break' figure, and will determine whether China's commitments have been sufficiently ambitious. Experts believe that if non-fossil fuel use can contribute to at least 25 per cent of total energy use by 2030, then the peak emission figure will be low enough to limit further environmental damage and could come earlier than the target year.

This is achievable. China began to experiment with low-carbon city development in 2010, with all pilot provinces and cities setting carbon emissions peaks. Twenty-three provinces and cities formed the Alliance of Peaking Pioneer Cities, committing to reaching the emissions limit ahead of the national schedule. Beijing, Guangzhou and Zhengjiang are aiming to beat the national goal by 10 years.

But China needs market-based approaches to complement administrative measures. Administrative steps can be effective but are often not efficient. Harnessing market forces to reduce energy consumption and cut carbon and other conventional pollutants will be crucial to success. Getting energy prices right is the first step in sending clear signals to both producers and consumers.

China has moved away from centrally planned pricing towards more market-oriented mechanisms, though the pace and scale of change differs between energy types. The natural gas price has long been set below production costs. Electricity has also lagged, with the government still retaining control over electricity tariffs. Thus, power pricing reforms are critical for internalising the cost of carbon in energy market prices.

CHINA is also reforming its narrow coverage of resource taxation, experimenting with seven pilot carbon trading schemes and preparing for the transition to a nationwide trading scheme by 2017.

A variety of existing programs and initiatives also need to be strengthened. For example, coal-fired power generation policies need to go beyond longer-standing policies on closing small, inefficient power plants while building larger, more efficient and cleaner units, given that existing coal power plants face falling utilisation rates, displacement by renewable energy sources and lower-than-expected demand. As of March 2016, such effects are already being felt, with the National Energy Administration ordering 13 provincial governments to stop issuing approvals for new coal-fired power plants until the end of 2017.

To ensure a smooth and successful transition to a green economy, more emphasis should be placed on economic restructuring, remodelling and innovation. Studies suggest that these factors have been underestimated in the past.

Eliminating outdated energy producers and tackling the perennial problem of overcapacity should also be at the top of the priority list. In the coal and steel industries, the government has announced targets to limit excess production capacity and imposed a three-year moratorium on new coal mine approvals. This supply-side reform is painful and will leave millions in need of alternative employment. The central government is well aware of the hard landing that some will face and has already set up funds to support those within the restructuring process.

China's green push is not completely new. Former leaders Hu Jintao and Wen Jiabao recognised the seriousness of environmental degradation in China and insisted that encouraging economic growth at the expense of the environment had to end. Environmental compliance costs are now even higher and will likely continue to rise as emissions targets become increasingly stringent amid widespread non-compliance with environmental regulations.

The difference this time is that China is being strict and methodical, implementing policies that will ensure change. This gives reason for optimism. EAFQ

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PICTURE: BEAWIHARTA / REUTERS

Youths read the Quran as they wait inside the Istiqlal mosque in Jakarta to break the fast during the holy month of Ramadan.

# Is Islamisation changing Indonesia and its regional role?

GREG FEALY

CONTEMPORARY Western perceptions of Indonesian Islam are dominated by two cross-cutting themes, one laudatory and the other fearful. The positive is that Indonesia, perhaps more than any other majority Muslim nation, represents a benign, pluralist expression of Islam. It is praised as one of the few successful democracies in the Islamic world and as a nation where minority faiths are respected.

On the other hand, Indonesia's moderation is seen as coming under growing threat from intolerant, Middle Eastern-derived Islamism. Evidence for this is found not only in the prevalence of terrorist violence but also in the broader trend towards social conservatism, a desire for greater implementation of Islamic law and rising sectarian attitudes towards non-Muslims.

Hence Western leaders and journalists often alternate between extolling Indonesia's moderate virtues and expressing concern that such moderation is imperilled. They particularly fear that Islamisation is undermining Indonesian democracy and social stability as well as making the nation less amenable to Western strategic agendas in Southeast Asia and the Muslim world.

Scholarly opinion on the nature of Islamisation in Indonesia is divided. Most researchers agree that Indonesia's Islam is becoming more conservative but disagree over the extent and long-term impact of this change.

But available evidence suggests that much of the anxiety over Indonesia's supposed 'Islamist turn' is unfounded. There has been no fundamental shift in the character of Indonesian Islam in recent decades or the role that it plays in the nation's politics and foreign policy. Though extremist and ultra-conservative elements are expanding on the fringes of the Islamic community, their influence upon mainstream religious and political life remains small.

Virtually all scholars of Indonesian Islam concur that levels of piety have increased steadily since the 1970s, though the percentage of Muslims in society has remained stable at about 88 per cent. Proof of this piety can be found in the proliferation of mosques, higher attendance at communal prayers and the growing popularity of Islamic fashion. Indonesia's burgeoning Islamic economy—sharia-compliant banking, insurance and share trading, for example—and the more prevalent use of Islamic symbols to promote mainstream products also reflect this trend. Greater devoutness is especially noticeable among urban, middle-class Muslims, not only in their lifestyles but also their personal practices.

Although strict observance of Islam's tenets is more widespread, has this changed the nature of Indonesian Islam? A common assumption among many commentators is that more Islamisation inevitably means more conservatism, as well as radicalisation. But the evidence for this is equivocal.

On the one hand, there are many signs of rising conservatism. This includes strong public endorsement of restrictions on supposedly 'deviant' groups that practice unorthodox forms of Islam, such as Ahmadiyah and local Islam-influenced folk beliefs. Support for more comprehensive enactment of Islamic law appears to be rising and social disapproval of so-called 'decadent' or 'immoral' behaviour, such as homosexuality and transgenderism, is commonplace. On the other hand, liberal Islamic intellectualism remains vibrant and there is little public support for extremist behaviour.

There are numerous causes of this accelerating Islamisation. One commonly mentioned factor is rapid socio-economic change that has destabilised traditional identities and impelled Muslims to seek certainty in literalist versions of their faith. Another factor is the state's promotion of Islamic orthodoxy through the formal education system. A third and much-debated factor is the impact of external forces, particularly Saudi-sponsored outreach.

In the Western imagination, Middle Eastern Islam is commonly associated with puritanism—often referred to as either Wahhabism or, more correctly, Salafism—as well as extremism and authoritarianism. Southeast Asian Islam, in contrast, is seen as culturally flexible, accommodating and friendlier to the non-Muslim world. It should be no surprise then that a perceived greater Middle Eastern influence on countries like Indonesia in recent years has drawn disapproving remarks from many Western nations and also the international media.

> Though extremist and ultra-conservative elements are expanding on the fringes of the Islamic community, their influence on mainstream religious and political life remains small

Among those making adverse comments was US President Barack Obama, who was reported in The Atlantic as having told Australian Prime Minister Malcolm Turnbull at the November 2015 APEC meeting that Indonesian Islam had now become much more Arabised and unforgiving compared with when he lived there as a child.

When Turnbull asked why this was, Obama replied that the Saudis and other Gulf Arabs had sent vast sums of money and large numbers of imams to Indonesia to promote fundamentalist Salafist teachings and educational institutions. Given Obama's childhood connection to Indonesia, his remarks were widely cited as informed analysis on Indonesian Islam's changing character.

A succession of articles over the past few years on the spread of Saudi-style Islam across Asia have mentioned Indonesia as a target country for the Salafists. Fareed Zakaria, for example, wrote in *The Washington Post* that Saudis have 'created a monster in the world of Islam … [which] had destroyed much of the diversity within Islam, snuffing out liberal and pluralistic interpretations'. The 'pernicious effects' of Saudi-funded Islamic extremism 'can be seen from Pakistan to Indonesia'.

A *New York Times* article by Scott Shane cast a similarly bleak picture of Salafism's growing impact on Islamic tolerance in Indonesia, quoting the respected terrorism analyst Sidney Jones as saying that Saudi influence had '[o]ver time contributed to a more conservative and intolerant atmosphere'.

The rise in recent media coverage

PICTURE: BEAWIHARTA / REUTERS

President Joko Widodo prays during Independence Day celebrations at the Presidential Palace in Jakarta. There has been no fundamental shift in the role that Islam plays in politics or foreign policy.

of the Salafist threat to Indonesia taps in to a discourse that has been present since the early 2000s about the spread of violent jihadist groups that are inspired and sometimes directly funded by Middle Eastern sources. Jemaah Islamiyah (JI), the jihadist organisation responsible for the 2002 Bali bombing that killed 202 people, was and remains aligned to al-Qaeda.

JI's primary purpose, however, has always been the founding of an Islamic state in Indonesia and surrounding countries, rather than terrorism as an end in itself. A more graphic Middle Eastern focus is found in pro-Islamic State (IS) groups that have emerged in Indonesia since early 2014. Their preoccupation is not Indonesia but rather supporting IS in Iraq and Syria as part of a commitment to establishing a global caliphate.

On some measures, Salafist thinking and activism is spreading quite rapidly in Indonesia, though from a very low base. Many hundreds of schools and mosques have been built with Saudi or Gulf money and they usually teach strict Salafist doctrine. There is also evidence that Salafist schools in many areas are integrating into the national curriculum. This allows them to receive state funding and place their teachers in local committees where they can exert influence on district educational policies.

But overall, the number of Salafist schools remains a tiny proportion of Indonesia's vast Islamic education sector. There are many areas where such schools are rejected and sometimes attacked by established mainstream Islamic groups.

Salafist media is very active, especially in radio and on the internet, and is often well resourced, but evidence regarding its reach and audience impact is at best equivocal. Most Salafist websites have fairly low click rates compared with mainstream sites. Salafist radio programs, despite sometimes enjoying wide syndication, do not appear to have attracted large and committed audiences.

In mainstream politics, Salafist influence is only detectable at the fringes. There are very few Salafists in legislatures at either the national or local level—many Salafists eschew politics—and it is hard to discern any policy clout they might hold with Islamic parties.

The one possible exception to this is the role of Salafist groups in fomenting anti-Shia and, to a lesser extent, anti-Ahmadiyah sentiment. Saudi groups have funded anti-Shia campaigns across the Muslim world in recent decades and some of Indonesia's most outspoken opponents of the Shia are Salafist.

Yet Salafist anti-Shia activism has failed to persuade either government or the National Ulama Council, Indonesia's top clerical body, to rule that Shias are not Muslim and move to outlaw the sect (as Malaysia does). Nor have they succeeded in having Indonesia reduce its ties with Iran.

Even for terrorist groups, the influence of Salafism is easily overstated. Most terrorists subscribe to a sub-category of Salafism known as Salafi-jihadism that regards violence as obligatory. But the great majority of Salafists are peaceable and abjure the use of terrorist violence. Research by Sidney Jones shows that very few of Indonesia's more than 1000 arrested terrorists have direct connections to Salafist organisations.

Salafist groups also face a mounting backlash against them. Nahdlatul

Ulama (NU), Indonesia's largest Islamic organisation, has for the past five years run a wide-ranging campaign to denounce Salafist teachings as contrary to the nation's traditions and cultural values. They accuse Salafists of sowing communal divisions and fostering extremism. Since 2015, NU has been promoting its concept of Islam Nusantara (Archipelagic Islam), which is strongly anti-Salafist and enjoys considerable government support as part of the state's counter-terrorism efforts.

One of the paradoxes of contemporary Indonesian Islam is that while piety has increased, support for Islamic parties has fallen. At Indonesia's first democratic election in 1955, Islamic parties gained 43 per cent of the national vote. At the two most recent democratic elections—2009 and 2014— the combined Islamic party vote was about 30 per cent.

There are several explanations for falling Islamic party support. The first is that Indonesia's increasingly devout Muslims have disconnected their religious beliefs from their voting behaviour, at least to the point that they no longer feel an obligation to vote for an Islamic party. They find a wide array of ways to express their Islamic beliefs and voting for an Islamic party is now regarded as, at best, optional.

Added to this is a growing disillusionment with the policy and managerial competence of Islamic parties. Surveys show that the more Islamic a party's identity, the less confidence voters will have in its capacity to govern well. Pious Muslim voters are preoccupied with economic growth, security and stability rather than having Islamic parties in government and overtly Islamic policies.

Indonesia's domestic politics and Muslim community sentiment intrudes into only a small number of foreign relations issues, such as support for a Palestinian state

Increasingly, Muslim voters are supporting parties that combine Islam with broader policy agendas, such that Islamic faith is only one of a number of elements that they are seeking in their political leaders. They prefer leaders who, like themselves, are pious, but not religiously threatening or rigid. Both the current president, Joko Widodo, and his predecessor, Susilo Bambang Yudhoyono, are good examples of politicians who cultivate an image of both religious rectitude and inclusivity.

This means that Islam is blended into national political discourses, rather than forming a separate stream within politics as it did half a century ago. All main political parties are now sensitive to Islamic issues. They have parliamentarians who represent a range of major Islamic organisations, but these are seldom dominant voices.

Foreign policy is another area where Islamisation has been assumed to have a major impact. It has not. Indonesia's domestic politics and Muslim community sentiment intrudes into only a small number of foreign relations issues, such as support for a Palestinian state and opposition to the repression of Muslims in Asian states. For the most part, successive governments have been driven primarily by pragmatic national interest. Indonesia is a member of the Organisation of Islamic Cooperation but its importance to the nation is far below that of ASEAN or the United Nations.

Indonesia has embarked on two international initiatives over the past decade in which Islamisation has played a role. The first is a greater attention to attracting 'Islamic investment' from Gulf states as a means of funding infrastructure development and Indonesia's expanding Islamic economy. The second is Indonesia's promoting itself as a moderate Muslim democracy that can serve as an example to other Muslim nations. While Gulf investment has surged, Indonesia's message of moderation has had little impact in Muslim communities abroad.

Islamisation's impact on Indonesia has been cultural rather than political. Indonesia's Islamic community is becoming increasingly variegated. One element of this is the proliferation of niches for severely puritanical doctrines such as Salafism and even Salafi-jihadism. But the vast Muslim mainstream, though somewhat more conservative, remains averse to sectarian and extremist messages. As a result, Indonesia's role in the region and broader world affairs is unlikely to change dramatically in the foreseeable future. EAFQ

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PICTURE: DAMIR SAGOLJ / REUTERS

Members of the Philippines' armed forces on a drug raid in Manila in October 2016. Rather than reduce crime, hard-line policies may consolidate drug groups.

# Cooperation critical to dealing with organised crime

RODERIC BROADHURST

THE immense demand for methamphetamines ('ice'), ecstasy and new psychoactive substances among the increasingly wealthy urban residents of East Asia—and beyond—has revitalised organised crime in the region. The scale of drug seizures in underground laboratories in Guangdong province alone is staggering. In January 2015, 2.2 tonnes of solid and liquid methamphetamine destined for Shanghai were uncovered in Lufeng. In May that year 1.3 tonnes of ketamine and 2.7 tonnes of precursors—substances that can be used to make illicit drugs—were uncovered in Yangjiang disguised as black tea bound for Southeast Asia and Taiwan.

Australian police working with Chinese authorities seized 720 litres of liquid methamphetamine in Sydney in February 2016. It was the largest bust on record, with a street value of A$900 million. The methamphetamine was originally shipped from southern China concealed in thousands of gel pads inserted into push-up bras and art supplies. Four Chinese men, residents of Hong Kong and the mainland, were arrested.

Bloated with cash and often enjoying a degree of state protection, organised crime groups constantly seek new markets—legitimate or illicit. By taking advantage of rapidly evolving forms of connectivity and regional trade, and mimicking best business practice while using violence strategically, these predatory groups can achieve impressive access to power.

The burden of transnational crime is often borne by communities in Southeast Asia. Insatiable demand for timber and wildlife products puts pressure on cash-strapped Southeast Asian communities to collude with criminal groups in extracting and marketing these resources. The Japanese yakuza and 'black societies' in Taiwan, Hong Kong and South Korea also seek opportunities to dump e-waste—discarded electronic devices—in under-regulated Southeast Asian jurisdictions. These lucrative markets, combined with the demand for counterfeit consumer and medicinal products, have proved irresistible to criminal enterprises.

Responding to these challenges are a handful of capable law enforcement agencies; a patchwork of cross-border mutual legal assistance agreements; and a fledgling, fragile regional security response from ASEAN, APEC and other multilateral fora. Given the changing scope and nature of organised crime in Asia, what kind of responses can have a lasting impact on these crime groups?

The United Nations Office of Drugs and Crime (UNODC) estimates that crime groups earned about US$90–100 billion per annum from illicit sources. The UNODC and Interpol have also highlighted the most prominent criminal activities: those most likely to affect economic growth, resource sustainability and governance in Southeast Asia.

Narcotic production and trafficking in precursors top the list, along with illegal wildlife and timber trading. In addition, human trafficking, illegal e-waste disposal, maritime crimes ranging from piracy to illegal fishing, counterfeiting of medicines and 'high street' products and underground gambling are among the most damaging transnational crimes.

Cross-border movement of illicit products into and out of Southeast Asia, often via India and China, has intensified in recent years. This is in part due to free-trade agreements between ASEAN and these countries, as well as the massive upgrade of the region's infrastructure and connectivity now underway. China's One Belt, One Road initiative, the India–Myanmar–Thailand Trilateral Highway and the Trans-Asian Railway are speeding up change and development in transport and commerce.

The proliferation of financial structures like the Asian Infrastructure Investment Bank reinforces this effect. Yet a recent UNODC assessment noted that, despite the existence of 'thriving networks of cross-border criminals', a 'fully operational framework on tackling cross-border crime does not exist'.

The blurring of legitimate with illegal business is an essential feature of organised crime, especially in the face of capable law-enforcement agencies. Also crucial is the ability to move money and profits that require expensive financial and legal services and stable 'safe havens'.

> Law-enforcement agencies now routinely observe convergence and connectivity among different Asian crime groups

Organised crime groups in East and Southeast Asia are diverse and often ephemeral. Some crime groups, such as the triads of southern China, have survived since the 19th century while others form and disband in a generation or less. The defining feature of organised crime is that it offers protection services—the enforcement of contracts—for illicit markets. And in some circumstances it can provide similar services in legal markets where state-led conflict resolution is weak.

A hallmark of protection is the willingness and ability to use violence. Violence is almost always strategic and instrumental. Though so-called 'honour contests' between rivals may occur in the short-term, sooner or later a monopoliser of criminal violence emerges. The role of protection remains central to the continuity of organised crime groups and remains the key element in capturing state actors or the merger of state and criminal power.

Law-enforcement agencies now routinely observe convergence and connectivity among different Asian crime groups. Former ethnic or linguistic distinctions once associated with traditional organised crime groups are now blurred. Major Chinese and Japanese crime groups are increasingly connected with West African, Iranian and South Asian crime groups. Mumbai groups such as D-Company have links with West African and Russian crime groups. Enclaves of African, Arab, Indian and Iranian traders operate openly in Tokyo, Guangzhou, Bangkok and other major centres of trade, often establishing 'no go' zones where civil authorities cannot operate effectively.

Connections between Chinese organised crime and Mexican crime groups such as the Sinaloa and Gulf

PICTURE: CHINA PHOTO / REUTERS


A Chinese policeman stands guard as 600 kilograms of drugs are destroyed in Guangzhou, Guangdong province. The southwestern Chinese province is a gateway for heroin traffickers from Thailand, Myanmar and Laos, who operate across 'a particularly lawless borderline'.

cartels have also been reported. This reflects the impact of the globalisation of trade and the increasing wealth of China, India and the region. Opportunities abound for expanding to new 'blue sky' industries or locations unhampered by existing protection providers.

Although common in the 20th century, fatal acts of violence are increasingly rare in Hong Kong, Macau, Taiwan, Japan and many parts of the Chinese mainland. Yet despite becoming gentrified, organised crime has not disappeared and many criminal actors remain associated with the old triads Sun Yee On, 14K and Wo Shing Wo, as well as the newer Big Circle Boys (Dai Heun Jai) crime network. Hong Kong, Macau and Taiwanese triads had by the 1990s established strong ties with criminal networks in Guangdong and Fujian. This allowed criminal groups to transfer the necessary capital and expertise to enable their enterprises to continue in more conducive settings.

Strategic violence still plays a crucial role in enforcing contracts in illicit markets and establishing distribution markets. Triads merged with or rented local protection services in China and Southeast Asia. These looser macro-criminal networks are often referred to as 'red-black' in Chinese, a euphemism for collaboration between the criminal world and corrupt elements of the state. This occurs especially frequently at the county level in China or at the sub-state level in the Golden Triangle, as the tri-state confluence of Myanmar, Laos and China is known.

It is a particularly lawless borderline, described by US historian Alfred McCoy and colleagues as the hub of the heroin trade during Cold War proxy conflicts—the source of the notorious 'French Connection' heroin route to Europe and the USA. The Triangle is now also known for the mass production of amphetamine-type stimulants (ATS) such as 'ecstasy', built on the older tradition of opium production and heroin refinement. The area's drug production genealogy goes back to displaced Shanghai 'Green Gang' chemists of the 1950s, its militarisation by detached nationalist warlord armies, the consequences of wars in Indochina and ethnic conflict within the Burmese state.

ATS, ice pills and heroin are transported from production areas in northeast Myanmar in modest quantities of a kilogram or less—under the prevailing legal threshold for trafficking—to markets in Bangkok. This method, known as 'ants moving house', earns the successful smuggler US$2000 per run. Larger amounts may be diverted via Cambodia for transhipment to highly profitable overseas markets like Australia, where premium wholesale prices beckon.

Most Asian governments have given economic development priority over concerns about illicit trade and organised crime. Without effective governance and rule of law, coupled with enhanced capacity among law enforcement agencies, it is likely that progress against organised crime and its harm will remain ad hoc. Capable agencies will not share crime intelligence that is likely to be compromised.

Central to the suppression of organised criminal activity will be the action of the ASEAN+3 group. China's rapid awakening to the high costs of fake and often dangerous products, as well as the perils of ice on the young, should help to reduce the scale of organised crime activities. Chinese-led restrictions on the export of precursor chemicals, effective from late 2015, should be significant if followed by India and ASEAN.

Genuine economic incentives are driving China's ongoing anti-corruption campaign, with a focus on the country's large, vulnerable state-owned small and medium enterprise sector. In this sector, 'grey' business has flourished and dual role entrepreneurs have navigated the nexus between the underworld and upper world with impunity.

The lack of effective action to suppress problems such as illegal drugs, counterfeiting and wildlife extraction reflects ASEAN's relatively weak integration with regard to non-traditional security problems. Until there is a sense that ASEAN is a community with a shared fate, effective co-ordination to combat organised crime is likely to be little more than window dressing.

Policies that reorient consumer choices to undercut the goods and services organised crime provides are also needed

Worthy but nonsensical aspirations and plans for a 'drug-free' region by 2015, set out at the 2010 ASEAN Ministerial Meeting on Transnational Crime, signal this weakness. Alternative policies that seek to regulate recreational drugs and the pursuit of harm-reduction strategies would help to undercut the profits of criminal groups, but at the same time greater recognition is needed of the contribution of consumer choice on the demand side. Policies that reorient consumer choices to undercut the goods and services organised crime provides are also needed.

Attempts to curtail demand by resorting to extrajudicial police killings may have popular appeal, but as with former Thai prime minister Thaskin Shinawatra's controversial 2003 war on drugs, Philippine President Rodrigo Duterte's bloody war on drug traffickers may ultimately serve to consolidate crime groups, raise protection costs and temporarily displace activities to less hostile locations.

A Philippine National Report released in September 2016 stated that since Duterte took over as president in July, 1466 drug crime suspects had been killed during police operations while 'vigilantes' had killed 1490. The high risk of homicides involving vigilantism marks a campaign that is out of control and highly corrosive of due process and the independence of courts. Duterte has pointed to a need for 'greater cooperation in the region, particularly in the capacity building and law enforcement efforts'. It is unlikely that Australian law-enforcement agencies will be keen to involve themselves in a bloody campaign that may encourage summary executions and undermine the rule of law.

Expertise in ensuring cooperation between Australian agencies and their neighbours has mutual benefits and provides some bulwark against the predatory conduct of criminal groups. Australia also provides significant support for many UNODC activities in the Asia Pacific, including the Illicit Crop Monitoring Programme.

Continued support for the independent assessment of emerging threats in both the traditional and non-traditional security spheres remains crucial to developing capabilities and to any hope of reducing the impact of transnational crime activities on Australia. Countries like Australia must keep in mind that the action is not just 'over there'. It depends on reducing the demand for illicit products and the predatory actions of criminal entrepreneurs, at home and abroad. EAFQ

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# Australia's political undertow


Tony Abbott on the path to the prime ministership in 2013. Australian politicians have come increasingly to rely on slogans, but voters have tuned out and trust across the electorate is at a low ebb.

PICTURE: PETER BARNES / REUTERS

HUGH MACKAY

IN THE 58 years from 1949 to 2007, Australian federal governments were defeated at the polls on only five occasions. Voters' reluctance to rock the political boat over those six decades was not necessarily a reflection of great satisfaction with politics—and the situation was complicated in the 1950s and '60s by the infamous Labor/Democratic Labor Party split. Rather it was a symptom of their desire for, at least, stability.

In that period, a one-term government was unthinkable. Governments were generally regarded as being committed to nation-building and to governing in accordance with a set of transparent political values. Leaders were not embarrassed to talk about their sense of vision and purpose; political idealism was expected of them.

In the nine years since 2007, no prime minister has survived his or her government's full term. The Liberal–National coalition government was returned to office in 2016 with the slimmest possible majority in the House of Representatives—one seat—surviving only through the strong showing of the minor coalition partner. The Liberal Party itself lost 13 seats and now holds just 45 in its own right, compared with Labor's 69.

Still, for Prime Minister Malcolm Turnbull, the result heralded 'a great day'. A few weeks later, apparently drawing inspiration from the Rio

PICTURE: MELODY AYRES-GRIFFITHS / FLICKR

Visitors to Parliament House admire portraits of prime ministers Bob Hawke and Paul Keating. Australian politics now lacks Keating's 'overarching narrative'.

Olympics, Foreign Minister Julie Bishop addressed the Western Australian branch conference of the Liberal Party and declared, with shining eyes, that 'we crossed the line first, we won', as if it were a gold medal at stake and the margin was irrelevant.

The total lack of humility was breathtaking. Given the government's near-death experience in the House, and the even more fragmented and independent Senate resulting from the ill-conceived double dissolution, former prime minister Tony Abbott was probably right to describe the government as being 'in office, but not in power'. And yet this government, like most governments, quickly adopted a winner-takes-all mentality, as if opposition members had no legitimacy.

In truth, the government probably survived only because of the electorate's misgivings about Labor leader Bill Shorten. But there's a deeper truth to be discerned in the 2016 election result: the days of political stability are over, at least for the time being. The power of incumbency has waned. The recent defeat of first-term governments in Victoria, Queensland and the Northern Territory is no mere coincidence, it's a sign of a very different mood emerging in the Australian electorate, characterised by scepticism, disillusionment and increasing alienation.

It is as if there are now two contrary currents running in Australian politics. On the surface, the major parties carry on as if they are the invincible primary force, committed to 'owning the game' and irritated by voters' insistence on electing so many independents and representatives of minor parties, especially to the Senate. The parties act increasingly like institutions corrupted by their own power, determined to protect their territory and to preserve their sources of funding; looking inward, rather than outward, for their sense of direction.

Like so many other institutions in Australia—the churches, the mass media, the banks and the trade unions—political parties are suffering a major slump in public esteem and respect. Party memberships are dwindling, just like church attendance, trade union membership and mass media audiences. Voters are more likely to swing than ever before. In response, the parties resort to simplistic slogans in a desperate attempt to recapture hearts and minds that have lost interest and wandered away.

Those slogans are a major part

of the problem. Not only the words themselves—'stop the boats', 'jobs and growth', 'continuity and change', 'putting people first'—but the mentality that says political leaders and parties are brands that should be marketed just like commercial products (though commercial marketeers know that endless repetition of the same message rapidly leads to boredom, irritation and switch-off: repetition with variation is the secret to keeping consumers attentive).

The emphasis on slogans has been increasing since 1972 when Whitlam's 'It's time' was credited with having defeated the McMahon government. It didn't: the McMahon government defeated itself. The nadir was reached with 'Kevin 07', a slogan completely devoid of content. And that slogan didn't win the 2007 election for Labor either. It was comprehensively lost by the tired and dispirited Howard government.

So how are voters' perceptions of politics and politicians affected when they see political parties being marketed like Coca-Cola? The answer is obvious: the whole process is trivialised in their minds. Parties come to be seen as 'brand A' or 'brand B'. Leaders come to be seen as walking billboards carrying slogans devised by back-room marketing consultants rather than political philosophers.

If you think the most creative and best-funded ad campaign can win you an election, then you have lost sight of the very essence of democracy. If you think a slogan can capture the minds of voters, then you have abdicated any right to be taken seriously. And if 'stop the boats' actually did win you an election, that would be all the proof we needed that politics had lost its way. (It didn't, of course—the Rudd Labor government lost office all by itself.)

The undertow in Australian politics has been partly generated by the political parties themselves, not only by their campaign methods but also by their parliamentary behaviour. When politicians treat each other with contempt, the entire institution is tarnished and voters turn away in disgust. If politicians treated their opponents with the respect due to them as legitimately elected members of parliament—to say nothing of the respect due to them as fellow human beings—not only would the ethos of politics be immeasurably improved but voters might also re-engage.

But the undertow is also a reaction to the failure of too many contemporary politicians to accept responsibility for moral as well as political leadership, their failure to inspire us and their failure to engage us in the process of dreaming of a better world while articulating strategies for getting there.

Following Keating's loss of office in 1996, 'the vision thing' became a term of opprobrium in Canberra, as if Keating's approach to politics was somehow discredited by his defeat. Ever since, politics has lacked what Keating referred to as the 'overarching narrative'—a coherent story that would bring all the strands of policy together and help people make sense of what was happening to them and to society.

> The first step towards greater social cohesion is to acknowledge that mutual kindness, compassion and respect are the essential prerequisites for any healthy society

Instead, society has become 'the economy'. Ideals have too often given way to raw pragmatism. Concepts like equity and fairness—let alone egalitarianism—become lost in the rapidly growing chasm between high and low income-earners, with Australia's gap now well above the OECD average. Short-term populism has swamped serious long-term planning for a sustainable future.

There was a glimpse of moral leadership when Kevin Rudd declared that global warming was the greatest moral challenge of our time. But there was no convincing policy follow-through. When Rudd actually sought to reduce the fuel excise so motorists would not be hit too hard by rising fuel costs, we assumed he was not serious. Public consciousness of the issue quickly evaporated.

Malcolm Turnbull excited the nation fleetingly when he deposed Tony Abbott in 2015. That excitement—indeed, euphoria—arose from the expectation that this was the kind of leader we were waiting for. On both sides of politics there was a brief period of confidence that Turnbull would offer just the kind of visionary, small 'l' liberalism we needed—that he had gravitas, that he would be strong and courageous, that he had a good mind and a good heart.

It was a moment when the undertow of cynicism might have ceased its destructive pull; when our faith in the idea of real reform might have been reignited. In everything from global warming, tax reform or marriage equality to poverty and homelessness, or putting a stop to the shameful mental torture being inflicted on asylum seekers in our offshore detention centres, Turnbull seemed to offer the promise of a fresh and vigorous approach.

Alas, as with the over-investment of faith in Rudd, the over-investment in Turnbull was soon exposed, and a searing sense of disappointment set in. 'Just another politician after all' became the way voters expressed their disenchantment. 'In thrall to the right wing of his party', said the many Labor voters who had briefly defected, at least in their minds, to the coalition.

And so the power of the undertow was restored. The sense of disconnection was reinforced. Disappointment finally gave way to a shrug of despair.

We are not alone in all this. In the United States, at the time of writing, voters are preparing to choose between Donald Trump, the most widely ridiculed candidate in US presidential history, and Hillary Clinton, perhaps the most widely loathed and mistrusted. As the contest descends into an unedifying slandering match, US voters' sense of outrage will grow, along with their feeling of remoteness from government and their regret at the loss of political integrity and vision.

The same undertow is tugging at UK politics, with the Brexit vote its most recent and obvious symptom. Again, that seems to have been about a disturbing sense of disconnection between the powerful elite and the mass of ordinary citizens, and a belief that if 'they' are telling us to stay, then we should leave.

But perhaps there's an even deeper undercurrent operating here. Perhaps contemporary politicians, themselves bred in an age of rampant materialism and individualism, have failed to grasp that some of our deepest human needs remain unmet by an over-emphasis on material prosperity and even on individual rights and entitlements.

Our epidemics of anxiety and depression suggest that all is not well with us. There are many reasons for that, but a big contributor is that, in spite of the information technology revolution—and, in part, because of it—and at a time when a deeply uncertain future demands strong social cohesion, we have become more socially fragmented. Affluence doesn't compensate for isolation, nor for the lack of a sense of purpose.

We are, by nature, social creatures. We need a strong sense of belonging to communities—families, friendship circles, neighbourhoods, churches, clubs, workplaces—if we are to experience the sort of wellbeing we yearn for. The first step towards greater social cohesion is to acknowledge that mutual kindness, compassion and respect are the essential prerequisites for any healthy society.

Budget repair is an urgent and worthy goal, but not a lofty one. It is only when politicians begin to address our human needs for sustainable wellbeing—physical, emotional, social, cultural and moral, as well as economic—that we will start listening again. The rest is noise.

*Hugh Mackay is a social researcher and author. His latest book,* Beyond Belief *(Macmillan, 2016), examines the changing role of religion in Australia.*


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# China's neighbours and the quest for regional community

Chinese President Xi Jinping and Philippine President Rodrigo Duterte arrive for a signing ceremony during Mr Duterte's visit to Beijing in October 2016.

ZHANG YUNLING

CHINA'S meteoric rise has put the spotlight on the relationships it shares with its neighbours. Distinct national interests and the substantial social and political diversity in the region make the development of a regional community a complex and delicate task.

China shares land borders with 14 countries and has eight maritime neighbours. But to truly understand China's relations with its neighbours, one must go beyond geography and consider how history, culture, geopolitics and geo-economics have shaped, and will continue to shape, these relationships.

Serious consideration must also be given to competitive national interests in the evolution of these increasingly interdependent relationships. The rise of China presents new challenges and opportunities for the development of neighbourhood relations and regional strategies. The close involvement of extra-regional powers, such as the United States, Japan and India, serves to further complicate China's relationships with its neighbours.

China and its neighbours have a shared interest in maintaining a peaceful and friendly relationship. If mishandled, all sides will suffer. This is the implication behind the Chinese leadership's call for a 'community of shared interests and common destiny' with its neighbours through a number of new initiatives. This new, grand strategy is underpinned by China's growing confidence in its ability to shape the regional environment. It reflects a new mode of strategic thinking on how to position China among its neighbours and how to understand the new importance of China's neighbouring regions.

China has developed initiatives to enhance regional ties, but the political, social and economic diversity among China's neighbours is immense. Relations are further complicated by conflicts of interest between the neighbours themselves, as well as by intervention from extra-regional powers, which engage in overt and covert competition in the region.

As China's influence rises, its neighbours' distrust grows. Some of them worry that China harbours ambitions for regional hegemony. Maritime and territorial disputes, over the exclusive economic zones in the East China Sea and South China Sea in particular, have resulted in rising tension between China, Japan and some ASEAN members. There has been widespread concern that confrontations may lead to a military conflict. The announcement and implementation of the United States' 'pivot to Asia' strategy, which stokes US–China competition in the region, has amplified these difficulties.

China's rise has triggered complex reactions among its neighbours. In some cases, it has exacerbated existing disputes. When China was weaker, disputes were more likely to be shelved—China often lacked the capacity to address them, and neighbouring countries considered their relations with China to be a lower priority.

As a rising power, China will naturally expand its interests and exert its influence. This could lead to competition and conflict, particularly with the United States. As a result, a growing sense of anxiety has emerged among regional states that fear that a strong China would seek regional hegemony at their expense.

Disputes among nations, including territorial disputes, should—for the sake of all involved—never be resolved by resort to war.

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**Towards Asian integration**

The Chinese leadership has recently called for building a 'community of shared interests and common destiny' among China and its neighbours

Traditional Chinese culture advocates peace and harmony, commends defusing contradictions, pursues reconciliation and believes in the tactical principle of subduing enemy troops without resorting to war. The time for China to display this 'culture of harmony' may be arriving.

The concept of harmony has shaped Chinese culture and politics for centuries. In September 2011, the Chinese State Council Information Office incorporated these values into China's foreign policy by releasing a white paper entitled 'China's Peaceful Development'. This report outlines the core values that should define China's strategic rise to global prominence, with an emphasis on the concept of a 'harmonious' culture.

The Chinese leadership has recently called for building a 'community of shared interests and common destiny' among China and its neighbours, based on the guiding principles of 'amity, sincerity, mutual benefit and inclusiveness'. But realising this communal dream will depend on the will and wisdom of both China and its neighbours.

Both sides have made great efforts to develop the China–ASEAN relationship. The China–ASEAN Free Trade Area and strategic partnership is just one example of an attempt by both parties to build a cooperative framework based on good will and real interests. But tensions in the South China Sea, especially in light of the Philippines' unilateral action through the Permanent Court of Arbitration in The Hague, have hampered progress. And the United States' military presence pours oil on the fire.

Fortunately, China and ASEAN have reconfirmed their commitment to a peaceful solution based on negotiations, and the Philippines' newly elected president, Rodrigo Duterte, supports this approach. Both China and ASEAN recognise that cooperation, rather than confrontation, will lead to the best outcome in handling the dispute. Such an agreement could be based on consultation and negotiation, focusing on easing regional tensions and finding the best way to allocate resources.

The process of regional cooperation helps to build up a sense of community spirit and shared interests. One of the most important changes for East Asia is that the foundation of regional cooperation is now based on a multilayered structure ranging from bilateral to regional-level mechanisms, such as the ASEAN+3 and +6 frameworks and the East Asia Summit.

China has so far played an active role in promoting this kind of regional cooperation, showing that what a rising China wants is to build and reinforce the regional community—not a China-dominated 'Middle Kingdom order'. EAFQ

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# ASEAN still the critical catalyst for China's future

KISHORE MAHBUBANI

CHINA is making some serious strategic mistakes in its dealings with ASEAN. It is sacrificing its long-term interests in favour of short-term objectives and its global interests in favour of regional concerns. And in the process, it is undermining a critical catalyst to its peaceful rise.

China's peaceful emergence as the number two power in the world is a modern geopolitical miracle. In 1980 its share of global GDP in purchasing power parity terms, was 2 per cent—far less than the 22 per cent the US accounted for. By 2014, China's share had overtaken the United States. Normally such great-power transitions are accompanied by competition and conflict. Instead, China emerged peacefully. Why?

Many factors were responsible. Deng Xiaoping's wise geopolitical advice to 'hide and bide' China's strength was a key factor. He also called on the Chinese 'to swallow bitter humiliation'. This they did. But it is impossible to swallow bitter humiliation forever. It was inevitable that China would eventually lose its patience and lash out against perceived maritime provocations by Japan and ASEAN. We can only hope that these recent outbursts have had a cathartic and calming effect on the national psyche.

Yet China's actions with ASEAN show that the anger has not abated. It is commonly believed that Chinese pressure led Cambodia to veto the ASEAN joint communique on the South China Sea in 2012. Similarly, China likely persuaded Cambodia, Laos and Thailand to walk away from the agreed ASEAN statement, later indiscreetly leaked by Malaysia.

China is one of the more rational geopolitical actors today. Unlike the United States and Russia, China's geopolitical actions are not commonly driven by emotional paroxysms. Yet China's atypical emotional defence of the infamous 'nine-dash line' in the South China Sea goes against its larger global interests.

China is now the world's number one trading power and has been since 2014. It is also the world's biggest exporter of manufactured goods. Chinese toothbrushes and detergents arrive safely on African and Latin American shores because the world's oceans are open to freedom of navigation and safe for commercial shipping. The US Navy is inadvertently doing the Chinese economy a big favour by keeping international sea lanes open. This has facilitated the near quadrupling of China's global trade from US$600 billion in 2004 to US$2.2 trillion in 2015.

Chinese Premier Li Keqiang greets Myanmar's State Counsellor Aung San Suu Kyi during the ASEAN-China summit in Vientiane in September 2016.
PICTURE: SOE ZEYA TUN / REUTERS

Yet in the same decade, when its reliance on freedom of navigation in the world's oceans increased, China prioritised regional interests ahead of its global interests. The nine-dash line, which had remained dormant for decades, suddenly surfaced in the Chinese public consciousness and the Chinese media began to defend it passionately.

It is against Chinese interests to convert any international waterway into an internal lake. This is why Wei Zongyou of Fudan University has wisely advised that: '[t]o avoid a possible maritime trap that will not only be detrimental to China's true national interests, but also negatively affect many other countries, China, as a major claimant, should think longer term and take steps to de-escalate the tension.'

The Chinese government has not decided to break up ASEAN. Indeed, it wants to strengthen ASEAN. Yet its actions have weakened ASEAN, a dangerous thing to do to an organisation that is inherently fragile—perhaps as fragile as a Ming vase.

More dangerously, China began to undermine ASEAN's unity. In theory, China can afford to alienate the 10 relatively weak ASEAN member states. In practice, China is shooting itself in the foot, since ASEAN's exceptional success as a regional organisation has also facilitated China's peaceful rise.

In the 1980s the strategic alignment of interests between ASEAN, China and the United States to reverse Vietnam's occupation of Cambodia enabled China to open up to the world. In the 1990s, after the West isolated China following the Tiananmen Square protests in 1989, ASEAN kept engaging with China. In the 2000s, ASEAN reacted enthusiastically to China's proposal for enhanced economic cooperation, which also coincided with China's entry into the WTO.

> Whenever relations between China and Japan broke down, their leaders turned to the ASEAN meetings to restore matters

China has also been exceptionally generous towards ASEAN. It stunned the world by being the first major economic power to propose a free trade agreement with ASEAN, motivating other powers to follow suit. China has been equally generous in its aid programs and was the first economic power to commit to enhancing ASEAN's infrastructure. As a result, there were, until recently, massive reservoirs of goodwill towards China in ASEAN. It's a tragedy that these reservoirs are now drying up.

ASEAN had responded positively to China's generosity. It facilitated China's rise in other salient ways. By converting the Balkans of Asia into one of the most peaceful regions in the world, ASEAN helped to change the chemistry of the larger East Asia region. China should look carefully at how Russia has been troubled by challenges in Ukraine and Syria. If Southeast Asia had emerged, like the Middle East, as a more troubled region, China would inevitably have been distracted.

Instead, ASEAN created a geopolitical oasis which helped maintain peace in East and South Asia. The annual ASEAN meetings provided the only safe and stable geopolitical platform for regional and great powers to talk to each other regularly. Whenever relations between China and Japan broke down, their leaders turned to the ASEAN meetings to restore matters.

ASEAN has therefore been a critical catalyst for the decades of peace that we have seen in the region. This is why the time has come for China to radically recalculate its interests in regards to ASEAN. Is the defence of the nine-dash line the 'core interest' of China in Southeast Asia? Or is it the continued success of ASEAN as a regional organisation promoting the culture of peace and prosperity in the broader region?

The answer almost seems obvious. This is what makes China's recent actions towards ASEAN truly puzzling. China is jeopardising its own interests in undermining ASEAN unity.

More importantly, as China's leaders frequently emphasise, China has not arrived as a modern developed power. Its per capita income is still only 25 per cent of the United States'. China still needs a few more peaceful decades to complete the job.

Ultimately, Deng Xiaoping was right when he called on the Chinese people to be patient. He was right in saying that the problem of territorial disputes should be passed to future generations. The problem of the South China Sea should be put on the backburner. China's larger interests in peaceful regional chemistry should push it towards preserving and strengthening the critical catalyst that has facilitated China's rise so far. EAFQ

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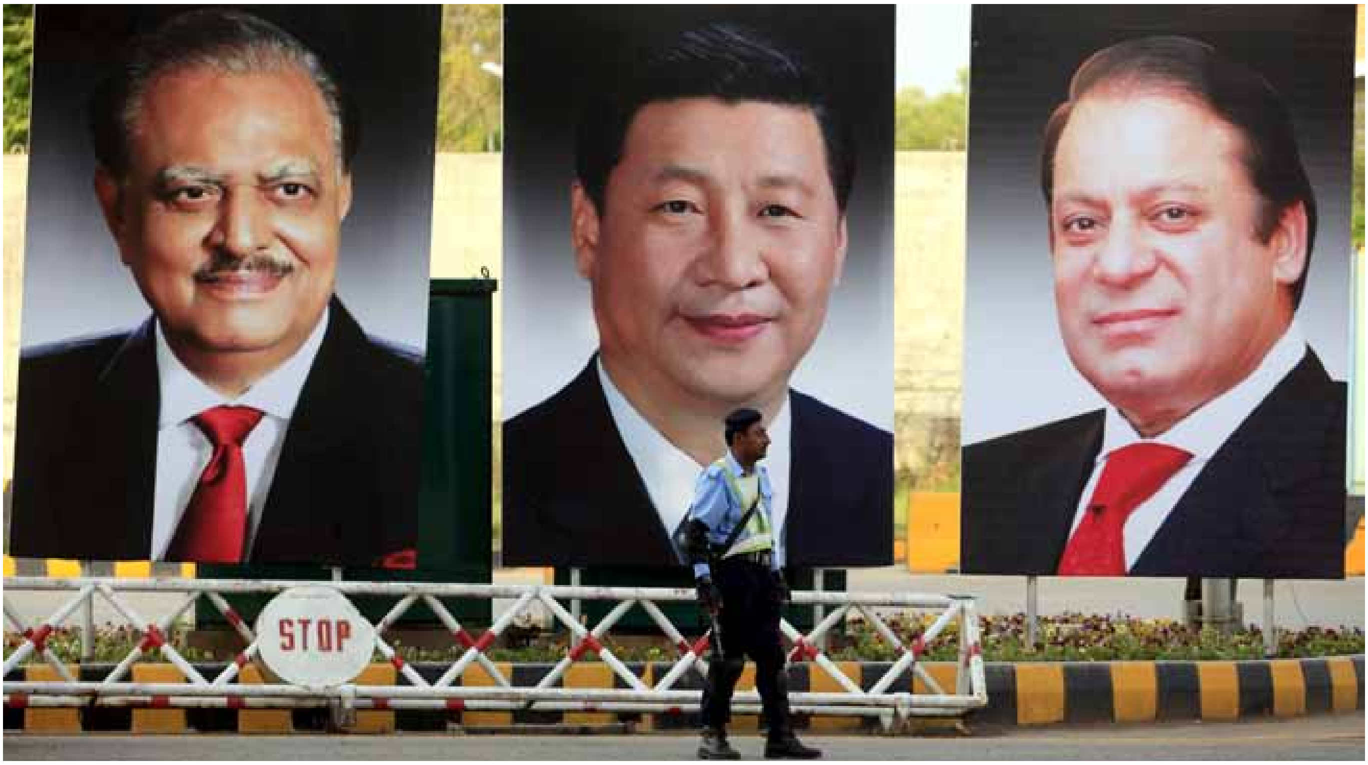
PICTURE: FAISAL MAHMOOD / REUTERS




A policeman stands watch in front of roadside billboard portraits of the leaders ahead of President Xi Jinping's visit to Islamabad in April 2015.

# China's Pakistan project: a geopolitical game-changer

DAVID BREWSTER

CHINA'S One Belt, One Road (OBOR) initiative is carving out new pathways across the Eurasian continent, signifying Beijing's ambitions to remake the world around it. This project, if implemented, will fundamentally change China's role and relationships in South Asia, perhaps in some ways that are not intended.

In the Indian Ocean region, OBOR has two aspects. One is the Maritime Silk Road, a series of linked port projects aimed at facilitating trade and new production chains linked with China by sea. The other is a series of planned north–south pathways from China to the Indian Ocean, including the China–Pakistan Economic Corridor (CPEC) and the Bangladesh–China–India–Myanmar Economic Corridor. These projects come with huge price tags and would involve the construction of roads, railways, pipelines and other major infrastructure in corridors stretching for hundreds and even thousands of kilometres.

Beijing has many motivations for these ambitious undertakings. Most immediately, they put to work Chinese infrastructure companies that are facing a tough domestic market. They also promise the development of new regional production chains with China at the centre. These corridors could also drive development in poor and politically unstable parts of Pakistan and Myanmar, potentially helping to stabilise those troubled countries. This reflects Beijing's views on the transformative impact of state-driven economic development. Chinese Premier Li Keqiang reportedly characterised the Chinese projects in Pakistan as a means to 'wean the populace from fundamentalism.'

But these new overland pathways also have the potential to fundamentally alter China's role in South Asia and the entire strategic make-up of the region. Geopolitically, South Asia has long functioned more or less as an island rather than as part of a bigger continent. Any overland connections that South Asia has with the rest of the continent are, at best, tenuous and excepting a tiny proportion of trade that is carried overland to and from Eurasia, essentially all of South Asia's connections with the rest of the world are by sea or air.

These geographic constraints have had considerable political, economic and strategic consequences for the region. One is in underpinning India's role as South Asia's predominant power. The relative lack of landward connections into the Eurasian continent also amplifies the importance of control over the maritime trade routes across the northern Indian Ocean.

GEOGRAPHY has also caused Eurasian states, such as China, to have very limited contact with their South Asian neighbours. Sitting on the other side of the Himalayas, China may as well have been on the other side of the world. While it has been a strategic player in South Asia for some time, it has been from far away. China's virtual remoteness allowed it to keep its hands clean of domestic political and security problems, even while it provided substantial military and diplomatic support to the Pakistani government. This has helped China to project itself as a benevolent partner that does not 'meddle' in internal affairs.

But China's role in the region may be about to fundamentally change. The CPEC will involve many thousands of Chinese engineers and workers building billions of dollars of infrastructure over thousands of kilometres of territory on a scale far exceeding any previous Chinese investments in Pakistan. While the final route is yet to be determined, the corridor will likely traverse the territories of Pakistan-occupied Kashmir, Gilgit-Baltistan and Balochistan. These are territories with long-running insurgencies or long histories of violent resistance to meddling foreigners.

Pakistan has sought to address CPEC security risks by forming a special army corps of 12,000 personnel devoted to protecting the project. But, at least until recently, China has been surprisingly sanguine about these risks and its ability to rely on the Pakistan Army.

If separatists or fundamentalist insurgents see benefit in attacking Chinese nationals and assets, then the Pakistan Army may be in for a difficult time. There are already past reports of Chinese security forces providing protection to Chinese workers in Pakistan-occupied Kashmir and it is not difficult to contemplate a growing Chinese security element in other Pakistani territories if the Pakistan Army is unable to cope by itself. CPEC also has the potential to enmesh China much more closely in Pakistan for reasons beyond just physical security, making it a key player in the country's internal political and security affairs.

India is still formulating its views about CPEC, but has already expressed outright opposition to some aspects. India's Foreign Secretary Subrahmanyam Jaishankar called OBOR a 'national initiative devised with national interest', stating that it was 'not incumbent on others to buy it'. Some in Delhi argue that anything that helps Pakistan's economic development and potentially stabilises the country would be a good thing for India. But one aspect that infuriates Delhi is China's plans to build infrastructure in Kashmir and Gilgit, territories claimed by India. India has repeatedly presented its strong objections to China without any apparent response.

We are already seeing some indications of a new geopolitical dynamic over CPEC. There is Beijing pushing for the Pakistan Army to be given a leading role—above that of any civilian authorities—in CPEC. Then there is the prospect of China's much closer involvement in Pakistan's domestic political affairs, both in Islamabad and regionally. And there is India, a major regional power looking for ways to threaten China's plans in Pakistan.

IN AUGUST 2016, in a national Independence Day speech, Indian Prime Minister Modi sent a clear message that India may begin to publicly support Balochistan's separatist insurgents. This represents a big shift for India and was directed almost as much at Beijing as at Islamabad. A senior and well-connected Chinese scholar responded that China will have 'to get involved' if India seeks to disrupt the CPEC. On 21 September, in the wake of the deterioration in Indo–Pakistan relations over Kashmir, Chinese Premier Li Keqiang publicly warned his civilian Pakistani counterpart, Nawaz Sharif, that he 'hoped' Pakistan can continue to provide safety protection to the program construction and Chinese personnel in Pakistan. These may well be the opening moves to a whole new strategic dynamic in South Asia driven by China's great OBOR ambitions.

EAFQ

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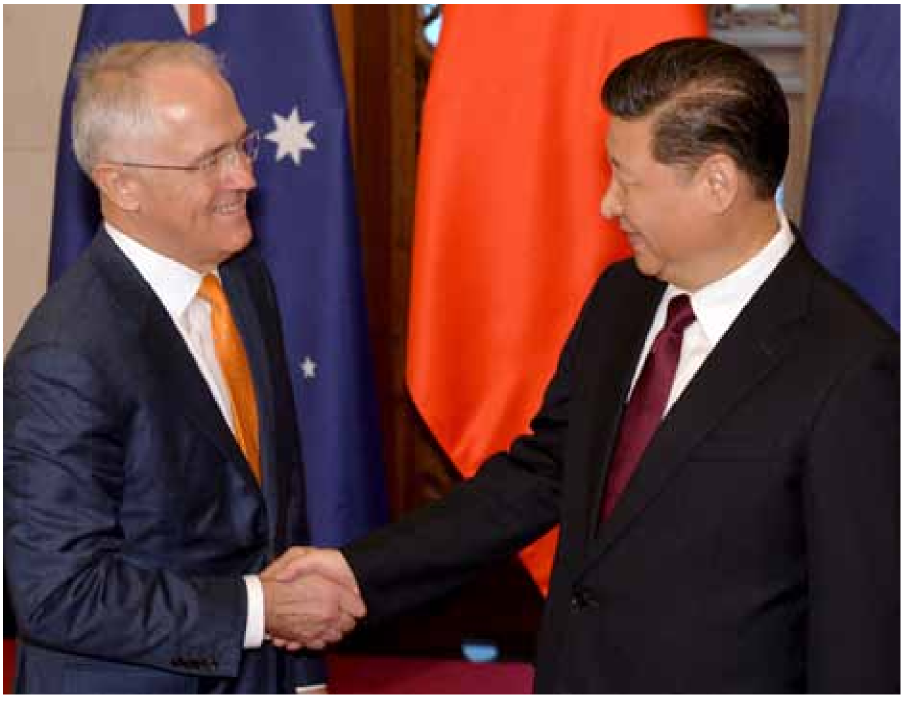
AUSTRALIA AND CHINA

# Committing to a partnership for change

PETER DRYSDALE
AND ZHANG XIAOQIANG

PICTURE: KENZABURO FUKUHARA / REUTERS



Australian Prime Minister Malcolm Turnbull and Chinese President Xi Jinping meet in Beijing in April 2016. The nations have the opportunity to develop a srategically vital and productive relationship.

AUSTRALIA and China, though they are two vastly different nations, already have a huge and joint political, economic and social investment in the success of their bilateral relationship.

Their unique partnership stems from a deep alignment of interests that, short of highly negative policy choices, cannot easily be undone. China is big, it is highly integrated into the world economy, and it is not about to go away. Australia is a secure source of raw materials for all of East Asia including China, it has an alliance relationship with the United States and it is enmeshed with Asia.

The Australia–China relationship will undergo a huge change over the coming decade. The scale and complexity of the relationship is growing because of the increased role of services and investment, as well as its political and security dimensions.

China has for some years been Australia's largest trading partner and one of its most important bilateral relationships. Australia's economic growth and continued rising living standards are strongly linked to China's economic success.

In the Chinese policy community, there is wide understanding and clear acknowledgement of the economic and political advantages of open, secure and competitive access to Australian raw materials.

As China's economy matures and its middle class expands, China is also enjoying the added dividend of access to Australian agriculture, institutions and services—everything from infant formula to vitamins, butter to beef, education to tourism, as well as advanced science, technology and research capabilities. Australia's open society provides Chinese investments with security in a stable and well-functioning market economy that guarantees transparent recourse to political, legal and regulatory institutions.

These new avenues of commercial exchange are a two-way street. Both Australia and China gain from growing and diversifying their economic relationship through new flows of tourists, students, investors and migrants. Despite recent slowdowns, China will remain a key driver of global growth. If China's reform agenda succeeds, it can achieve annual GDP growth of around 6 per cent a year over the next 10 years.

The impact of China's growth on Australia over the next 10 years will be very different from in the past. Australia will no longer only be a remote supplier of raw materials. It should be a palpable and distinctive presence in Chinese daily life, particularly for the urban middle classes.

Australia is economically enmeshed with East Asia, giving it a high stake in China's success. It also has strong economic, cultural and strategic links to the United States, and therefore a compelling interest in a positive relationship between the United States and China.

Australia's geopolitical and geo-economic position and its multicultural society are thus unique assets in shaping China's links with the West.

Chinese and Australian prosperity has depended on the liberal, rules-based global economic system. Both countries have a compelling interest in the successful adaptation of the institutions of global governance to the economic and security challenges of the 21st century. A deeper partnership between China and Australia can be a powerful force for strengthening and developing these institutions. Australia's longstanding commitment to global institutions, its deep engagement with Asia and its historical ties with Europe and North America are complementary to China's status as a major economic power and its declared willingness to help reform and strengthen the regional and global frameworks of cooperation and governance.

China is shifting its growth drivers from investment, exports and heavy industry to consumption, innovation and services. China's growth slowdown does not threaten this transformation; it is a symptom of it.

This transformation will lead to fast growth in trade between Australia and China in real terms, much of it in services. Even in a pessimistic scenario, in which average Chinese growth is below 5 per cent over the next 10 years, estimates suggest that Australian exports to China would still grow by 28 per cent and Chinese exports to Australia by 20 per cent. The biggest gains, however, would be realised if Australia and China work to implement supply-side reforms. If this reform agenda is executed successfully, Australian exports to China will grow by 120 per cent in real terms, and Chinese exports to Australia by 44 per cent.

The structural changes in the Chinese economy presage a change in the structure of trade. The profound complementarity stemming from Australia's energy and resource abundance and China's industrialisation will remain a key pillar of the relationship, but will be increasingly augmented by services such as education and tourism, with inbound tourism from China set to treble by 2025.

There is every reason to believe that the Australia–China relationship will become more, not less, important to both countries as the Chinese economy continues to change and upgrade.

The need for an upgraded policy framework is broadly accepted in both countries.

That will be a complex task: it will require building a new set of national capabilities in both countries.

In the 1980s, Australia and China established what they called a 'model relationship' between two economies with different political and social systems and at different stages of development. Now both countries need to commit to a partnership for change.

This year we presented a major independent report on how a partnership for change might be fashioned by the governments and people of our two countries. It draws on the expertise, wisdom and common sentiments across governments, business leaderships, research communities and public leaders. It is an unprecedented endeavour at working together in thinking about the choices we make for the future.

The Australia–China relationship represents an impressive achievement but with wisdom it can be taken to a wholly new level. While fully respectful of each other's existing relationships, the new partnership can be a powerful force for the stability and prosperity of the region, and for the global system. It can serve as a principal vector of Australian and Chinese engagement within a rapidly changing world. Nurtured carefully and imaginatively, this deeper partnership could become one of the most strategically vital and productive bilateral relationships that either country has in the world. EAFQ

> . . . the new partnership can be a powerful force for the stability and prosperity of the region, and for the global system

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*They are lead authors of* Partnership for Change, *a major independent Australia–China joint economic report, published by ANU Press in August 2016.*

PICTURE: BOBBY YIP / REUTERS


A man looks at Smithfield products at a Shuanghui news conference in Hong Kong in March 2016. The Chinese interest acquired the US meat processor in 2013.

# Weighing up China's investment in the US

THEODORE H. MORAN

CHINESE investment flows into the United States have reached unprecedented heights over the past two years and the future promises more of the same. Inward investment from China climbed to US$18 billion in the first six months of 2016, a threefold increase over the same period in 2015. The acquisition of US companies accounts for 84 per cent of these investments.

Two questions stand out when considering the future of Chinese investment in the United States. The Committee on Foreign Investment in the United States (CFIUS) is the country's key body for evaluating the domestic effects of inbound foreign investment. Is CFIUS likely to rule against many of these Chinese acquisitions on national security grounds? And what will be the impact on the US economy of those Chinese investments that are allowed to proceed?

In the most highly publicised CFIUS case since 2009, ChemChina proposed to acquire the Swiss agribusiness firm Syngenta in February 2016 for a record US$44 billion. Syngenta enjoys a 21–24 per cent share of the US market for pesticides and insecticides. Senator Charles Grassley of Iowa asserted that this acquisition would threaten US 'food security', and demanded that Secretary of Agriculture Tom Vilsack be added to the CFIUS review committee. The Obama administration complied as a courtesy, but when no plausible national security threat could be uncovered, the ChemChina acquisition was approved on 21 August with no mitigation whatsoever.

The Syngenta case paralleled the takeover of US meat processing firm Smithfield by the Chinese firm Shuanghui International in 2013. In this instance, Senator Debbie Stabenow of Michigan held special Senate hearings to protest against the sale, but once again CFIUS approved the Chinese acquisition without difficulty.

CFIUS regulations were rewritten in 2009, in part to help regularise the relationship between CFIUS proceedings and Congress.

The redraft left the definition of threats to national security open-ended, but analysis of CFIUS cases shows that these threats can be separated into four distinct types. For each type, there are clear conditions that determine whether or not the threat is seen as credible.

THE first type of threat is the possible leakage of sensitive technology to a foreign company or government that might deploy or sell such technology in a way that harms US national interests. Assessing the plausibility of this threat is a two-step process. Step one is to calculate the damage that could be done if the technology were deployed against US interests. Step two is to calculate how readily available such technology is in international markets. If the acquired firm's technology is widespread and relatively simple to acquire, national security will not be served by blocking the transaction.

CFIUS encountered this threat in 2015, when Dutch giant Philips agreed to a US$3.3 billion deal to sell 80 per cent of its Lumileds division to Chinese investor GO Scale Capital. At first glance, the sale might appear to involve nothing more the transfer of a standard commercial lighting affiliate to Chinese control. But closer investigation revealed that Philips was experimenting with equipment that utilises a substance called gallium nitride, used in the production of advanced radar and anti-ballistic missile systems. CFIUS refused permission for the acquisition, claiming jurisdiction over the proposal due to Philips' significant presence in the US market.

Neither Philips nor CFIUS would comment on why the acquisition was blocked but the common assessment among experts is that CFIUS saw in this sale the potential transfer of sensitive technology to the Chinese government.

The second threat springs from the ability of the foreign acquirer to delay, deny, or place conditions on the provision of output from the newly acquired producer. The acquirer could be doing this independently or under instructions from their home government. Evaluating this second threat—the manipulation of access—also requires a two-step analytic process.

CFIUS first considers how 'crucial' or 'critical' the process or product is—what is the cost of delaying or doing without this product? The next step is determining the abundance of near-substitutes to the process or product in question, and how high the costs of switching are. If the goods and services of the company being acquired are widely available and switching costs are low, there is no plausible threat to US national security.

In 2015 a Chinese mining company made a non-public proposal to acquire a Canadian mining firm that owned rare earths properties in Canada, the United States and South Africa. China already controls approximately 90 per cent of rare earth exports, which are critical commodities for the aerospace and automotive industries. The Chinese government has ordered the withholding of rare earth exports to Japan during periods when territorial disputes have flared up. CFIUS joined its Canadian counterpart in advising the parties that the deal would not be permitted to take place. This illustrated the threat of denial or manipulation of access to critical inputs for which there are few readily available substitutes.

The third threat is that the acquisition might allow a foreign company or government to watch over, monitor or place 'time bombs' within the US company's systems. This third threat is particularly prominent in assessing foreign acquisitions involving critical infrastructure.

Figuring out how to cope with this threat in a world of globalised supply chains—especially in the information technology (IT) sector—creates difficult quandaries for CFIUS. All the basic building blocks of IT systems—servers, routers, data storage and retrieval mechanisms, flash drives and microchips—have hardware and software components from production sites in China, Taiwan, Russia, Israel, Eastern Europe, Malaysia, the Philippines and Mexico. All of these are susceptible to surreptitious engineering inputs.

It is an illusion to think that this kind of threat can be eliminated by singling out and discriminating against providers on the basis of the parent company's national origin. It would be misguided and ineffective to reject Chinese-owned providers while allowing purchases from US, French or Swedish firms whose assembly facilities are adjacent to the Chinese-owned plants in Shenzhen.

In Lenovo's proposed acquisition of IBM's X86 server business, CFIUS had to face the conundrum of globalised supply chains head-on. The low-end

X86 server had been widely used by businesses, government defence and intelligence agencies, and principal IT trunk carriers like AT&T and Verizon. The concern was that these commonplace X86 servers might become a vehicle for some kind of penetration by Chinese agencies.

But most X86s were already produced in China, by companies like Hewlett-Packard and Dell as well as by IBM, using thousands of Chinese engineers and tens of thousands of Chinese inputs. Since CFIUS approved this acquisition, it must have concluded that the marginal increase in security threat that Lenovo ownership presented was insignificant.

The fourth and final potential threat arises if the target US firm has properties close to US military installations.

In March 2012, without reporting the transaction to CFIUS, the Ralls Corporation, a Chinese-owned firm, acquired several US wind farm projects. The projects' towers overlooked restricted Naval Weapons Systems Training Facility airspace, where the newest generations of drones are tested. In June, CFIUS contacted Ralls and requested that the firm file a voluntary notification to have its investment retroactively reviewed. After giving the acquisition a preliminary examination, CFIUS asked that Ralls stop operations until a complete investigation could be completed.

Based on that investigation, including confidential US Navy inputs, CFIUS recommended that President Barack Obama block the investment by ordering a divestment of the transaction as well as removal of equipment already installed. This was only the second such formal US prevention of a foreign acquisition.

Chinese investment in the United States has been growing rapidly from a very low base. Lindsay Oldenski and I created a model of Chinese foreign direct investment (FDI) to find out what the future of Chinese FDI in the United States might look like. The model takes into account variables like per capita income, distance between countries and shared languages—factors that are typically correlated with trade and investment flows.

Based on these variables, the model can predict the size of FDI flows between any two given countries. China's investment in the United States, despite recent growth, remains no more than half of what would be expected on the basis of the two countries' other characteristics. The model predicts large and steady increases of Chinese FDI in the United States in years to come.

Using a different predictive model, based on market size, natural resources and governance, China specialist David Dollar has shown that China is underinvested in the United States. He concludes that flows from China can be expected to rise rapidly in coming years.

WHAT impact will these new and greater investment flows from China have on the US economy? Looking at the Chinese FDI that has already taken place, the evidence reveals that Chinese investors provide jobs with wages and benefits substantially higher than industry averages, on par with the higher wages paid by US affiliates of firms headquartered in developed countries. This is not surprising—Chinese companies come to the United States not just to sell goods and services, but to conduct research and development, and gain management expertise. Future flows of Chinese FDI are likely to provide good jobs to American workers.

When foreigners invest in the United States, their presence provides productivity 'spillovers' to other firms in the sectors where they invest. Investors can bring about these spillovers by introducing additional resources, technologies or expertise to a domestic industry. These effects are not small—an outstanding 12 per cent of the United States' total productivity growth from 1987 to 2007 can be attributed to productivity spillovers from inward FDI.

Will the same be true for Chinese investors? Somewhat surprisingly, foreign investment on the part of companies from developing countries, including China, are already also generating significant productivity spillovers. What's more, these are likely to continue and grow in magnitude.

Within these rising flows of Chinese FDI, it will be possible to separate rigorously those acquisitions that might pose a genuine national security threat from those that do not.

Foreign acquisitions can only bring about a credible national security threat under very specific conditions. Careful assessment will show that very few inward acquisitions will pose any national security threat whatsoever to the United States. The overwhelming bulk of Chinese investments can be welcomed without hesitation, their presence greatly beneficial to US workers, firms, communities and consumers. EAFQ

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PICTURE: ALY SONG / REUTERS

Shoppers throng Shanghai's Nanjing Pedestrian Road, once dominated by 'Australian' department stores.

# Australia must capitalise on the Chinese diaspora

PETER CAI

NANJING Road is arguably one of the most famous shopping strips in Shanghai, the commercial capital of China. In the 1930s four great department stores—Sincere, Wing On, Sun Sun and Sun Company—dominated the streetscape. These towering buildings boasted elaborate window displays and were modelled after Anthony Hordern & Sons in Sydney.

These four great department stores were known as the 'Australian stores' because they were owned by Chinese Australians. Sadly, the entrepreneurs are all but forgotten outside of their families, according to John Fitzgerald, one of Australia's foremost historians of China.

Chinese Australians made up the largest group of investors in Shanghai before Mao took power in 1949. They contributed as much as one-third of total overseas Chinese investment and also made substantial outlays in Hong Kong, Guangzhou and Tianjin.

This chapter of Australian business history continues today in a different form. One of the most vital but underestimated linkages between Australia and China is the country's one million-plus Chinese Australian community. This group plays an increasingly important role in facilitating trade and investment flows, as well as promoting science and business innovation.

Its role was officially recognised as early as 1995, when the Department of Foreign Affairs and Trade prepared a report outlining the importance of overseas Chinese business networks in Asia for the government's standing committee of deputy secretaries on Asia.

The report argued that the diverse

and growing Chinese communities in Australia contributed significantly to Australia's economic wellbeing domestically, regionally and internationally. Australia's Chinese communities could assist non-Chinese Australian businesses to trade and invest in China, Taiwan, Hong Kong and other regional economies where ethnic Chinese are important suppliers, consumers and financiers.

China-born migrants are the third-largest immigrant group in Australia after people from the United Kingdom and New Zealand, constituting 2 per cent of Australia's total population. In a recent study, two German economists, Jan Priebe and Robert Rudolf, estimated that between 1970 and 2010, Chinese immigrants across 147 countries boosted trade openness by 31 per cent and increased investment by 18 per cent in their new countries.

As Australia's exports to China undergo transition from commodities to services, the Chinese diaspora is expected to play an even greater role in facilitating more trade and investment. Chinese-born Australian financier George Wang is an example. He is the chairman of the AIMS Financial Group and he acquired the Asia Pacific Stock Exchange in 2008.

Wang wants the stock exchange to be a bridge between capital-hungry Chinese companies and Australia's AU$2 trillion superannuation system. In China, small- and medium-sized enterprises have to pay usurious interest to secure funding.

In recent years *daigou* (Chinese personal shoppers) have also become a new force in the China–Australia trade relationship. There are an estimated 40,000 active *daigou*, which includes students, housewives, young professionals and grandmothers sending parcels from Australia to China. This industry is worth more than US$1 billion, according to a conservative industry estimate.

*Daigou* have played an important role in helping Australian health care products to expand and brand in China. This army of personal shoppers has already helped a handful of Australian vitamin and baby formula companies—such as Swisse, Bellamy's and Blackmores—grow to billion-dollar valuations.

The Australian Population and Migration Research Centre at the University of Adelaide finds that Chinese students can play a crucial role in the state's wine business as it seeks to make inroads into the Chinese market. One medium-sized winery in Adelaide Hills began generating significant sales in China after employing a Chinese student. The student began addressing occasional enquiries from Chinese customers before creating a position for herself as the winery's lead China strategist.

These examples illustrate just a small part of the growing importance of the Chinese diaspora in fostering bilateral economic ties. Yet the Australian government and business sector is not taking advantage of this vital human asset. A recent report by the Australian Council of Learned Academies (ACLA) argues that the country should make better use of this talent pool.

> Australia's Asian business diasporas are a rich source of innovation, enterprise and entrepreneurialism. Yet they are underutilised

'Australia's Asian business diasporas are a rich source of innovation, enterprise and entrepreneurialism. Yet they are underutilised,' the report says. 'They have significant potential to further enhance Australia's economic engagement with Asia and help the nation's economy to thrive, for the benefit of all Australians.'

How should Australia take advantage of the Chinese business diasporas? One suggestion from the ACLA report is to allow for greater representation and participation by Chinese and Indian Australians in the development of policies. The council recommends establishing programs aimed at strengthening Australia's economic, political and cultural relations with Asia.

This underrepresentation is evident across the board from public office to industry councils and business. In corporate Australia, only around 4 per cent of ASX top 200 companies have board directors of Asian descent. The ACLA report points out that '[g]reater recognition needs to be given to the leadership roles that Australians of Asian origins can potentially play in driving more effective engagement with Asia.'

For the foreseeable future, China is likely to be Australia's most important economic partner, both as an export destination and a provider of capital. The country's ethnic Chinese population of over one million is a vital part of this bilateral link. Government, business and academic research institutions all need to take advantage of these human links. EAFQ

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