Special report: China

Rising power, anxious state

In less than a decade China could be the world's largest economy. But its continued economic success is under threat from a resurgence of the state and resistance to further reform, says James Miles

Jun 23rd 2011 | from the print edition

AT THE HEIGHT of the Qing dynasty, back in the 1700s, China enjoyed a golden age. Barbarians were in awe of the empire and rapacious foreigners had not yet begun hammering at the door. It was a *shengshi*, an age of prosperity. Now some Chinese nationalists say that, thanks to the Communist Party and its economic prowess, another *shengshi* has arrived. Last year China became the world's biggest manufacturer, displacing America from a position it had held for more than a century. In less than a decade it could become the world's largest economy. Foreigners are again agape.

China's rapid recovery from the global financial crisis, and the West's continuing malaise, have had a profound psychological impact on many Chinese. Emotions ranging from pride to *Schadenfreude* permeate official rhetoric. Diplomats treat their Western counterparts with a tinge of condescension. What is great about socialism, crowed the prime minister, Wen Jiabao, in March last year, is that it enables China "to make decisions efficiently, organise effectively and concentrate resources to accomplish large undertakings". In the eyes of some Chinese, and even some foreigners, authoritarianism has gained a new legitimacy.

A big parade of missiles, tanks and goose-stepping soldiers in central Beijing in October 2009, the capital's first such display in a decade, was described in official reports as a "grand ceremony of the *shengshi*". A group of generals and senior officials enlisted 60 artists to commemorate the party's 60th year in power that year by painting a 120-metre-long scroll called "A Picture of a Chinese Harmonious *Shengshi*". The panorama depicted the soaring skylines of China's great cities, interlaced with the mountains, rivers and clouds beloved of traditional painters. There were ethnic minorities dancing joyously in Tiananmen Square, a rocket taking off, a wind farm and even a mist-wrapped Taiwan. In the past couple of years the *shengshi* has brought the recalcitrant island closer, with cross-strait flights and a free-trade deal.

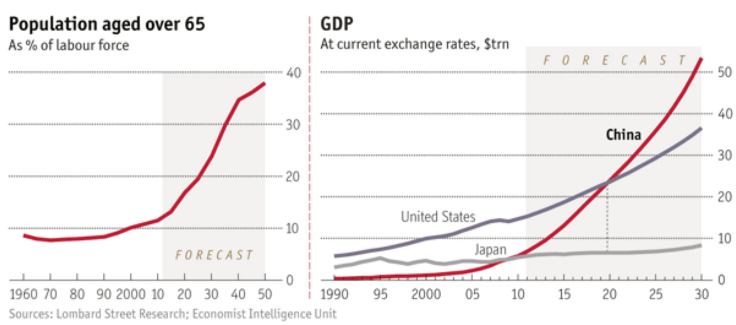
To some observers in an insecure West, the balance of global power is shifting inexorably in China's favour. Recent book titles capture the mood: "In the Jaws of the Dragon: America's Fate in the Coming Era of Chinese Hegemony" (by Eamonn Fingleton, 2008); "When China Rules the World: The End of the Western World and the Birth of a New Global Order" (by Martin Jacques, 2009); "The Beijing Consensus: How China's Authoritarian Model Will Dominate the Twenty-First Century" (by Stefan Halper, 2010). As William Kirby of Harvard University notes, anxious books about China's rise have a long history in the West. There was a spate of them in the early 20th century: "New Forces in Old China: An Unwelcome But Inevitable Awakening", by Arthur Brown, set the tone in 1904. But other rising powers—Japan, Germany and America—got even more attention. Today China is the chief object of worry.

Chinese publishers have been cashing in too. Bookshops (which stock only works of which the party approves) are stacked with volumes on the “China model” and the failure of liberal economics. The Chinese Academy of Social Sciences struck a rare note of modesty in a report last October. It rated China a mere 17th in a global league of “national competitiveness”. But it pointed out that the country had risen from 73rd place in 1990 and had left India, which was ranked 42nd, in the dust. China’s aim, the report said, should be to reach the top five by 2020 and be second only to America by 2050. Its universities are producing swelling legions of scientists, but it seems there are still not enough of them to allow the country to join the top ranks just yet.

All change

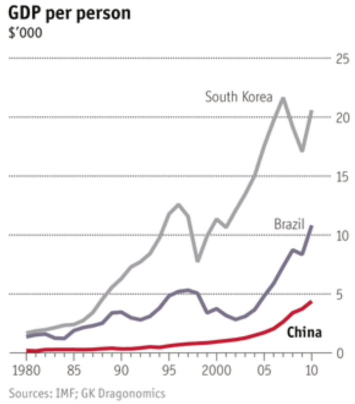
For all the chest-thumping, though, China’s leaders are more cautious than either their underlings or the state-controlled publishing industry. They avoid the term “China model” and do not publicly boast of a *shengshi*, even though they allow their media to talk of one. Indeed, they appear more nervous now than at any time for over a decade. They have massively increased spending on domestic security, which in this year’s budget has overtaken that on defence for the first time. The government has been reviving a Maoist system of neighbourhood surveillance by civilian volunteers. In the past few months the police have launched an all-out assault on civil society, arresting dozens of lawyers, NGO activists, bloggers and even artists. The Arab revolutions have spooked the leadership. From its perspective, the system looks vulnerable.

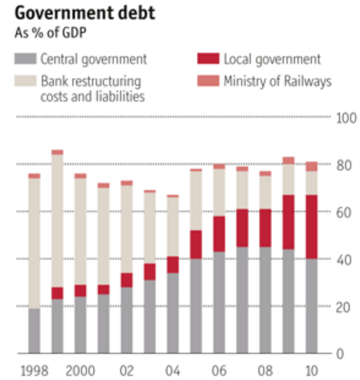
Chinese leaders have other reasons to fret. Late next year, probably in October, the party will hold a national congress, the 18th since its founding 90 years ago. This meeting, a smaller one of the party’s central committee immediately afterwards and a session of the legislature in March 2013 will endorse the biggest shuffle in China’s leadership for a decade. The president, Hu Jintao, and Mr Wen will step down from the pinnacle of power, the nine-member standing committee of the Politburo. A younger generation will begin to take over. Leadership changes on this scale always make officials anxious. Although the most recent one, in 2002, passed without incident, earlier such transitions triggered dramatic events: a coup in 1976, debilitating power struggles in 1986-89 and mass unrest in 1989. Just because the last one went well does not mean this one will.



The new leadership will not have such an easy ride with the economy, which on average has grown by over 10% a year since 2002, despite the trauma of the global financial crisis. China’s demographic advantage—an abundant supply of labour in the countryside—is beginning to wane. In a few years the working-age population will peak. Without huge and politically risky policy changes it will become increasingly difficult to maintain the rapid rate of urbanisation that has been one of the main drivers of growth. Looking towards the 2020s, many Chinese economists worry about falling into a “middle-income trap”: losing competitiveness in labour-intensive industries but failing to gain new sources of growth from innovation.

China's leaders will find it enormously difficult to rebalance China's economy so that growth is led by consumption rather than by exports and investment. Their efforts will be hampered by the growing clout of state-owned businesses. In the past decade these have risen from the ashes of tens of thousands of government-owned enterprises dismantled in the 1990s. Their numbers are now much smaller, but their economic and political influence is enormous and growing.





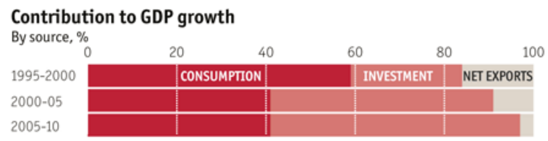
Banks are still almost entirely in government hands. Their profligate lending to other parts of the state empire, in order to keep the economy booming after the financial crisis, will revive a bad-debt problem that China thought it had licked years ago. Many of the descendants of those who led the party when it came to power in 1949—the likely big winners in next year's realignment—have strong ties with state-owned firms.

Key political terms

National party congress
Convened every five years; its next meeting is expected in October 2012. Its 2,200-odd delegates are "elected" by lower-level party congresses, but in practice chosen by the party's secretive Organisation Department.

Politburo
A 25-strong body whose members are nominally chosen by the Communist Party's Central Committee, but in practice by a diverse range of the party elite. Nine are also members of the Politburo Standing Committee, the party's top decision-making body.

Leftists
Supporters of a strong role of government in the economy, including Maoists as well as members of the "new left" who resent the inequalities that have arisen from the country's embrace of capitalism.



China is likely to disappoint those who believed that the country's embrace of globalisation would usher in greater political freedoms over the next few years. James Mann, an American journalist, gave warning of this in a 2007 book, "The China Fantasy: Why Capitalism Will Not Bring Democracy to China", suggesting that a quarter of a century from now China's "current system of modernised, business-supported repression could well be vastly more established and entrenched". A lot can happen in 25 years, but the line-up for next year's change of leadership does not give cause for optimism.

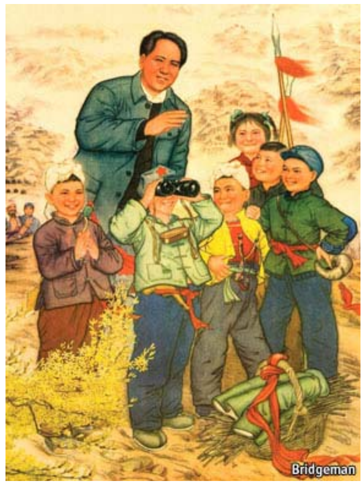
from the print edition | Special report

China's new leaders

The princelings are coming

Next year's changes in the leadership will bring on a new generation of privileged political heirs

Jun 23rd 2011 | from the print edition


Bridgeman

THE RUGGED REMOTENESS of Chongqing, a region in south-western China about the size of Austria, made it an ideal temporary home for the government during the Japanese invasion in the 1930s-40s. In the 1960s Mao Zedong moved strategic industries there to protect them from a feared Soviet invasion. Recently Chongqing has become a stronghold of something rarely seen in China since Mao's day: charismatic politics.

The region's party chief, Bo Xilai, is campaigning for a place on the Politburo Standing Committee in next year's leadership shuffle. He looks likely to succeed. Like every other Chinese politician since 1949, he avoids stating his ambitions openly, but his courting of the media and his attempts to woo the public leave no one in any doubt. Mr Bo's upfront style is a radical departure from the backroom politicking that has long been the hallmark of Communist rule and would seem like a refreshing change, were it not that some of his supporters see him as the Vladimir Putin of China. Mr Bo is a populist with an iron fist. He has waged the biggest crackdown on mafia-style gangs in his country in recent years. He has also been trying to foster a mini-cult of Mao, perhaps in an effort to appeal to those who are disillusioned with China's cut-throat capitalism.

He does not appear to be aiming for the very top. Hu Jintao's posts of president, party chief and military commander are almost certain to go to Xi Jinping, the vice-president, and Wen Jiabao's job as prime minister is likely to be taken by Li Keqiang, his senior deputy. But Mr Bo could well be offered the portfolio of China's internal security chief, currently held by Zhou Yongkang, with whom he is believed to have close ties. This would give him huge clout in the new line-up. Xinhua, a government-run news agency, in December named Chongqing as China's "happiest" city, in a hint that Mr Bo is destined for great things.

Both Mr Bo and Mr Xi belong to an emerging political force in China commonly known as the *taizidang*, or "party of princelings". These are the offspring of senior officials, including Mao's old comrades-in-arms. Mr Xi is the son of Xi Zhongxun, a hero of the epic Long March of the 1930s. Mr Bo's father, Bo Yibo, was also a Long Marcher. Both fathers held senior positions under Deng Xiaoping. In the 1990s the princelings were viewed with great suspicion by many in the party who resented their use of blood ties to secure top positions, but in more recent years party leaders appear to have rallied around them. They probably calculate that people like Mr Bo and Mr Xi are the safest bet for upholding the party's traditions, and crucially for holding on to its monopoly of power.

> In the 1990s the princelings were viewed with great suspicion by many in the party, but recently party leaders appear to have rallied around them

Mr Xi (who adores Hollywood movies about the second world war, according to a WikiLeaks cable) and the Jaguar-loving Mr Bo exude the sort of self-confidence that comes with a privileged upbringing. Like Western celebrities, they excite much tattle, albeit not in the party-controlled media. Mr Xi's wife, Peng Liyuan, is a glamorous folk-singing star in the People's Liberation Army. A foreign businessman calls Mr Bo China's "best-dressed person". His son, Bo Guagua, is now studying at Harvard University after a stint at Oxford where his raffish behaviour, caught on camera, became an internet sensation in China (notwithstanding the censors' best efforts).

The new left

Despite such diversions, Mr Bo is a darling of China's "leftists". These include diehard Maoists (who are a marginal force in Chinese politics, but still enjoy some appeal among retired officials and workers laid off from state-owned enterprises) as well as social democrats who want a fairer distribution of wealth. Many in this camp believe that China is far from enjoying the golden age now being proclaimed by some. The country is too divided between rich and poor to be experiencing a *shengshi*.

Mr Bo's Maoist revival has included a campaign to encourage the singing of "red songs", especially classics from the Mao era (one official newspaper cited Chongqing residents' enthusiasm for this as one reason for its "happiest" award). Mr Bo himself has taken the stage with fellow officials to croon a few numbers, and has issued a list of 27 favourites (including "I Am a Soldier", from the early days of Communist rule, and "China, China, the Bright Red Sun Will Never Set", from 1977, the year after Mao's death). In Chongqing, party cells in universities, schools, government offices and state-owned businesses organise red-song clubs and competitions. The Chongqing government has even been encouraging citizens to send "red instant messages" on their mobile phones. Mr Bo took the lead by sending one citing the Great Helmsman: "What really counts in the world is conscientiousness, and the Communist Party is most particular about being conscientious." Tens of thousands of Chongqing officials are now required to spend a week every year living and working with a peasant family.

Bo Xilai and Peng Liyuan add a touch of glamour to the world of Xi Jinping (centre)

Chinese leaders may shy away from claiming to have found a "China model", but Chongqing's leaders are not so bashful. Piled up in the foyer of the city's main government-owned bookshop are volumes of a new work called "The Chongqing Model". Written by three leftist scholars, it reads like a manifesto for Mr Bo. The authors say the anti-mafia campaign will help prevent a "colour revolution" of the kind experienced by numerous former communist states and by some Arab nations in recent years. They speak of the "original sin" of private entrepreneurs who got rich by shady means. The anti-mafia drive, they quote the city's mayor, Huang Qifan, as saying, helped restore order to "an economy of scoundrels, an economy of rascals". Mafia-controlled businesses, the writers say, employed 200,000 people. By stepping in and assuming "trusteeship", the government ensured that none of them lost their jobs.

Liberals in Beijing worry that Mr Bo's campaign has shown little regard for legal process, much less the independence (however notional) of the judicial system. Police and judges have been instructed by party cadres whom to target and what punishments to mete out. A prominent defence lawyer hired by one alleged mafia boss was himself jailed for allegedly attempting to persuade his client to lie in court. Some independent lawyers in Beijing say Mr Bo's real motive was to deter lawyers from acting for accused

gangsters. Liberals fear that the crackdown on dissent in China in recent months will continue even after the princelings have taken power because the new leaders will be fearful of challenges to their authority.

The authors of the "The Chongqing Model" would like to steer the economy onto a different path. They speak scornfully of Shenzhen, a freewheeling "special economic zone" bordering on Hong Kong beloved of China's liberal economists. They prefer a bigger role for the state. Chongqing officials proudly note that the municipality, which ranked 19th among Chinese provinces by value of its state assets in 2003, has since moved up to number four, thanks to a more than sevenfold increase in their worth to 1.25 trillion yuan ($192 billion).

But Mr Bo's predilection for state-owned enterprises has a populist streak too. Whereas most such firms in China hand over little of their profit to the state, causing widespread resentment, officials claim that Chongqing's state businesses have been supporting projects for the less well off. These include a huge one launched in 2010 to build 800,000 subsidised apartments within three years, at a cost of 120 billion yuan ($18.5 billion).

This housing scheme has been widely praised in the national media. But as this special report will argue, if China's state-owned enterprises enjoy a renaissance under China's new leaders, it will be to the detriment of competition and increased consumption as a new driver of growth. Politically, their growing power (along with the salaries and benefits enjoyed by their employees) is likely to exacerbate social tensions, especially if China's growth falters, forcing private companies to scale back.

Mr Hu at least will be able to point to a legacy of his decade in power that makes many Chinese proud: double-digit annual growth and a much higher global profile. Mr Xi's rule could be far more troubled.

from the print edition | Special report

Growth prospects

Beware the middle-income trap

China's roaring growth cannot last indefinitely

Jun 23rd 2011 | from the print edition

But will they consume enough?

CHINA'S LEADERS ARE usually shy of telling things as they are, but the prime minister, Wen Jiabao, put it bluntly when he described China's economy in 2007 as "unstable, unbalanced, unco-ordinated and unsustainable". Some foreigners may extol China's handling of the global financial crisis, but Mr Wen has stuck to his guns. The phrase even crops up in China's recently adopted five-year economic plan, standing out as an indirect admission of the failings of his own administration and as a marker for the next.

For all its problems, China in the coming 10-15 years is still likely to reach several symbolic milestones. The IMF predicts that in 2016 it will become the world's largest economy on a purchasing-power-parity basis. The Economist Intelligence Unit, a sister organisation of this newspaper, reckons that on the basis of market exchange rates China will attain that glory in 2020. By the end of this decade, according to Daiwa Securities, GDP per person in Shanghai, China's richest city, could be almost the same as the average for America in 2009.

And for all the bubbliness of China's property market and the reckless spending of local governments, the country will probably avoid a crippling debt crisis. China has foreign-exchange reserves of more than $3 trillion and ran a modest budget deficit of 2.5% of GDP last year. Its worries are longer-term. The economy will certainly begin to slow in the next few years after three decades of nearly 10% average annual growth. Exports will be constrained by depressed Western markets, and investments in fixed assets will produce diminishing returns. But the slowdown will be less pronounced if the government succeeds in boosting consumption as a new growth engine.

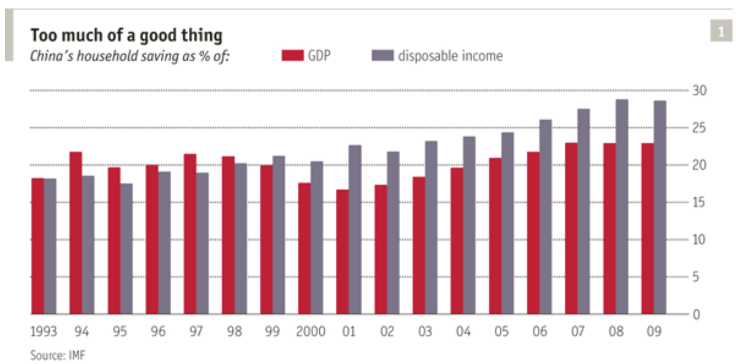
Arthur Kroeber of GK Dragonomics, a consultancy, says the country still enjoys a considerable tailwind from urbanisation and a huge potential for productivity gains as it adopts new technology. He says a scattering of white-elephant projects (including the odd ghost-town of uninhabited new housing and office developments) does not concern him: "There's no question that there are excesses, but the basic thing they are doing is sensible." Louis Kuijs of the World Bank agrees. He sees the trend growth rate easing over the coming decade, but not dramatically. New infrastructure is generally being put to good use. Even though investment as a proportion of GDP is high, China's accumulated investment in fixed assets is still low. Real wages have been rising strongly, which should help boost consumption. Standard Chartered, a bank, says that although China's public debt is considerably higher than the 17% of GDP officially cited, it remains manageable. Even after allowing for bad loans to local-government investment companies, it runs at 80% of GDP, the bank estimates, about the same as Britain's last year and well below Greece's.

Chinese leaders are perennial worriers about inflation, not least because of its role in fuelling the discontent that led to the Tiananmen Square protests of 1989. But even though it rose to 5.5% in May, considerably above the government's 4% target for the year, it shows little sign as yet of returning to previous highs of about 20% in 1988 and more than 25% in 1994. It also has a useful political side-effect, easing some of China's tension with America over the value of its currency. America's Treasury says that because of the higher inflation rate in China, the yuan is in effect appreciating against the dollar by more than 10% a year. Chinese leaders have been debating whether to push interest rates higher, but Mr Kuijs says Chinese policymakers have become more tolerant of medium rates of inflation.

Yukon Huang of the Carnegie Endowment for International Peace, a think-tank in Washington, DC, says doomsayers are wrong to be so concerned about the fall in the ratio of household consumption to GDP. True, it has dropped from around 50% two decades ago to 35% today, among the lowest levels in the world, whereas investment is among the world's highest; but such a decline, he says, is not unusual for an industrialising country. The efficiency of stimulus spending may be questionable, "but how efficient do you expect stimulus money to be?" He thinks growth could remain at 7-8% for a long time.

The bears' grumbles

But many analysts are far less sanguine. Some worry that China could be approaching a Japanese-style crisis: a boom in exports and investment along with bubbly property markets, followed by many years of stagnation. In China's case the added sting would be that it has not yet got rich. Officials and experts debate endlessly whether the country is slowly heading towards a "middle-income trap". China was already a lower-middle-income country last year, with a GDP per person of around $4,400. The fear is that it might suffer the same stagnation and turbulence as Latin American economies in the 1980s and 1990s.

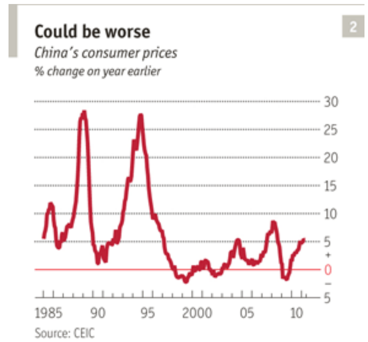


The drafters of the new five-year plan adopted in March were clearly hoping to head off such a calamity. Five-year plans have evolved since the Mao era when they were used by the government to micromanage the economy, but they are still meant to play a crucial role in setting the economic tone. "China model" fans love them because, at least in theory, they commit leaders to an economic strategy that will not be undermined by the chop-and-change policymaking of democracies. When Mr Wen's successor takes over in 2013, the current plan will still have more than two years to run. It calls for faster change in the "pattern of economic development" to address the imbalances, and sees boosting consumption as critical to this.

Mr Wen himself is no touter of a China model. His previous five-year plan, which took effect in 2006, was also intended to shift the economy away from too much reliance on exports and investment. It set a target of 7.5% annual growth in GDP for the plan period, against 8% for the previous one. Instead, the rate accelerated to about 11% a year, compared with an average of 9.5% in the first half of the decade. Household consumption as a proportion of GDP fell sharply. And China's 4 trillion yuan stimulus programme (about $620 billion at current exchange rates), launched in November 2008, allowed banks to lend almost at will, mostly to state-owned enterprises, raising the prospect of a flood of new bad debt.

Despite Mr Wen's calls for more evenly shared prosperity, the gap between rich and poor and between cities and countryside has continued to widen. Since he took office in 2003, absolute poverty has dropped markedly. But the number of people in relative poverty (with 50% or less of the median income) grew from 12.2% of the population to 14.6% between 2002 and 2007, according to research by Terry Sicular of the University of Western Ontario and Li Shi and Luo

Chuliang of Beijing Normal University. By the end of the plan period the goal of establishing a "harmonious socialist society", a favourite catchphrase of Mr Wen's and Mr Hu's, appeared even more remote than at the beginning. Protests over local injustices, already running at tens of thousands a year, were becoming ever more frequent.



The new five-year plan adopted in March notes that the "external environment" for China's development has become "more complicated". In other words, markets abroad do not look promising. It calls for a "strategic readjustment" in China's growth model, putting even more emphasis than its predecessor on domestic demand, especially consumption. It still envisages big investments, but in the hope that these will boost household consumption in the longer term. It promises 36m new "affordable housing" units, more than Britain's entire housing stock. The hope is that cheaper homes will make it easier for the Chinese to get into the housing market without having to save quite so much. And the government has pledged to ramp up spending on health, education and other social-welfare programmes. Eventually too this could encourage people to save less and consume more.

The government also wants the high-speed railway network, already the world's longest at 8,300km, to quintuple in length by 2015. Beijing, having completed one of the world's largest airport terminal buildings in 2008, will get a whole new airport. So will 54 other cities, increasing the total number with airports by nearly one-third. These investments, officials hope, will help to boost urban growth, and with it consumption. Infrastructure targets are usually met in China because governments have little trouble with not-in-my-backyard protests.

But some economists believe this is all too much. Among the bears is Michael Pettis of Peking University, who believes that investments are becoming increasingly inefficient and that China is heading towards a "brick wall" of government debt. Growth, he says, will remain high in the early half of the decade but could drop off sharply thereafter as loans turn sour. Even in the best case, he says, growth will fall below 5%. Victor Shih of Northwestern University also points to a looming debt problem, exacerbated by the recklessness of local governments during China's stimulus-spending spree. Not being allowed to borrow directly, many of them set up companies to borrow on their behalf, using land as collateral. "There is a hidden danger of an asset bubble and [we] are facing a certain financial risk," wrote Yu Peiwei of the party's Policy Research Office in January. If the bubble bursts, land prices could plummet, leaving the banks dangerously exposed.

Bingeing on investment

Nouriel Roubini of New York University, a chronic bear, is in this camp. In a recent article he argued that the brick wall will most likely be hit between 2013 and 2015. He noted that China was spared a recession in the wake of the financial crisis because investment in fixed assets, such as transport infrastructure and factories, increased from an already very high 42% of GDP in 2008 to nearly 50% in 2010. No country, he says, could be productive enough to invest 50% of GDP in new fixed assets without eventually facing "immense overcapacity and a staggering non-performing loan problem".

It is not just foreigners who worry. Ge Zhaoqiang, a senior researcher at China Merchants Bank, gave warning in May that China's economy had become "seriously distorted" by prolonged dependence on high levels of investment. There was now a risk, he said, of an economic downturn "unprecedented in the past 30 years" with possibly damaging consequences for China's social and political stability.

If China is not to stagnate, it will have to make a bigger effort to persuade rural dwellers to keep coming to the cities as its population ages ever more rapidly. In 1980 one-fifth of China's people lived in urban areas. Today the figure is 49.7%. Very soon the country will become predominantly urban, with over 51.5% forecast to be living in urban areas by the end of the five-year plan. This implies a slower pace of urbanisation than in the past decade. For once, however, the government is not setting its goals too low. In future urbanisation will indeed become harder.

from the print edition | Special report

Special report: China

Urbanisation

Where do you live?

Town- and country-dwellers have radically different prospects

Jun 23rd 2011 | from the print edition

Rus in urbe

IN DAYI COUNTY, a couple of hours' drive down a motorway from the city of Chengdu, the capital of Sichuan Province, Chinese tourists stroll through the meandering courtyards of a rural mansion. In the 1950s, soon after Mao seized power, the mansion was turned into a museum, intended as a showcase of evil. It once belonged to Liu Wencai, a landowner supposedly notorious for ill-treating his tenant farmers. Liu embodied a class despised by Mao, who came to power on the back of a promise to give land back to the peasants.

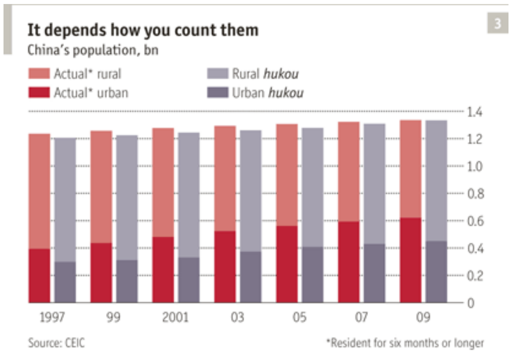
In its Maoist heyday the museum was a place of pilgrimage. Red Guards swarmed there for ritual denunciations of Liu and his ilk. A high point of their visit was a trip to the "water dungeon", a room with several inches of water covering the floor where Liu had allegedly kept disobedient farmers. Another was a series of life-size sculptures of peasants and their vicious oppressors. A politically disfavoured curator from Beijing's Forbidden City who happened to look like Liu was forced to stand next to the sculptures as a "living Liu Wencai" so that visitors could shout and (though not strictly permitted) spit at him, according to Geremie Barmé of Australian National University.

The sculptures are still there, but in recent years a wave of revisionism has been sweeping across Dayi. Local officials were already having second thoughts by the early 1980s. But it was a book reassessing Liu's life published by an outspoken journalist in 1999 that finally convinced many that the man was really not that bad. His water dungeon was a government fabrication, the museum now points out. He spent a lot of money on local schools and paid for a road to be built from Chengdu to Dayi. Last year a grandson organised a get-together in Dayi for the extended Liu clan, whose members would once have been terrified of revealing their ties. More than 1,000 turned up.

The slaughter of many thousands of landlords (not including Liu, who died of natural causes) by officials and vengeful peasants shortly after the communist takeover resulted in profound changes in the system of rural land ownership. Peasants got the land Mao promised them, but only briefly. In the late 1950s the party took it back again and forced farmers into collectively owned "people's communes". The legacy of that disastrous decision, which contributed to a famine that left tens of millions dead, still weighs heavily on rural China. So too does a decision to confer hereditary status on peasants, who would be all but barred from cities to stop them rushing in to find work.

The curse of the hukou

The *hukou* system, as this one-time apartheid is commonly known, applied to urban as well as rural dwellers, but peasants got a worse deal because they received hardly any welfare benefits, and job prospects in the countryside were dismal. The system has been much eroded since the Mao era because of the need for cheap labour to fuel China's manufacturing boom. But its lingering impact, combined with the still collective ownership of rural land, will retard China's urbanisation in the years ahead just when the country is most in need of its consumption-boosting benefits. Two researchers from China's finance ministry, Chen Xiaoqiang and Liu Ling, wrote in March that it was time to start returning land to the peasants, both to spur consumption and to help defuse growing rural unrest. Most officials dare not say this so bluntly, but they admit that change is needed.



In 2007 Chengdu, and Chongqing to its south-east, were given licence to experiment. The principle of collective ownership could not be changed, but farmers' rights could be clarified and rural land markets of sorts could be established. In Chengdu, which is responsible for a large rural area including Dayi county, officials spoke of initiating a "new land reform" (hinting at similarities to the great land reform that divvied up the estate of landlord Liu). They began a drive to ensure that farmers at last got long-promised certificates showing the exact boundaries of their fields and housing as well as confirming their rights to use them (farmland is subject to a 30-year renewable contract).

Without such documents a market could not take off. Regulations dating back at least to 1997 have obliged officials to issue them. But Landesa, an American NGO, says a survey it conducted in mid-2010 in 17 provinces, along with Renmin University and Michigan State University, found that only 44% of respondents had a complete set of certificates. One in three had no documents at all. In April the central government urged the whole country to finish issuing the certificates by the end of 2012. Dayi county, chosen by Chengdu as a trailblazer for land reform, says it got the job done by the middle of last year. But one peasant fumes that officials never bothered to give her any documents and seized her house and farmland a few months ago for a development project. "Liu was a great landlord," she says. "I wish officials today were like him."

Both Chengdu and Chongqing have gone a step further. They have set up markets for rural land derivatives, allowing farmers who create new land for agricultural use (by giving up some of their housing plots, for example) to sell the right to use an equivalent amount of rural land for urban development. Thus a developer who wants to build on a greenfield site that has already been approved for urban construction bids first for a "land ticket", or *dipiao*, which certifies that such an area of farmland has been created elsewhere. The regulations say farmers get 85% of the proceeds: good news, in theory, for those in remote, dirt-poor areas who would otherwise have no chance of cashing in on the value created by urban expansion.

This is hardly revolutionary. Especially for Chongqing's Mao-loving party chief, Bo Xilai, doing good by the peasantry would seem a canny move. But because the notion of the collective persists, the system is wide open to abuses. Local officials have considerable incentives to force farmers to give up housing land and move to more compact dwellings in order to create land for *dipiao* trading (some of the proceeds of which also go to village authorities). The *dipiao* markets in Chongqing and Chengdu have done little more than add a layer of complexity to a widespread trend in many parts of China that has often added to peasants' grievances.

In the name of building a "new socialist countryside" (a slogan launched in 2005), local governments have been corralling farmers into new apartment blocks in order to free up land which they can use for profitable purposes. Officials have justified the practice as a way of reducing incentives for local governments forcibly to appropriate farmland and sell it to developers. Two million peasants a year have lost their land this way in the past five years, a senior government adviser in north-east China said in March. The new strategy often means the farmers are crammed into apartments with no backyards to raise chickens or store tools, and they face a longer journey to their fields.

Reform might quickly be exploited by the very forces it is meant to constrain: rapacious local governments and developers

Though officially sanctioned, the *dipiao* markets are viewed warily by the central leadership. Late last year Chengdu's market was suddenly closed down. No clear explanation was given, but a Chinese scholar says higher-level officials worried that *dipiao* were being traded without land having first been converted to agricultural use. The risk, central officials feared, was that it would never happen at all. The market reopened in April, but the central government remains cautious. In Chongqing only 10% of the government's annual sales of undeveloped rural land are subject to the *dipiao* system.

Thoroughgoing land reform, of the sort that would enable farmers to cash in on the value of their farmland and establish permanent and prosperous lives in cities (and at the same time encourage larger-scale farming), thus remains stuck. One obstacle is ideological: for all their economic pragmatism, many in the party still regard collectivism as a sacred principle. Privatisation remains a dirty word. A more practical worry is that reform might quickly be exploited by the very forces it is meant to constrain: rapacious local governments and developers. These, it is feared, would take advantage of any changes to persuade farmers unaware of land values to sell their holdings at less than market rates. The numbers of poor, landless peasants would soar, creating huge instability.

Reformers in Beijing argue that most farmers are far cannier than officials suspect. But the global financial crisis has strengthened the case for caution in the minds of party leaders. As many as 20m workers returned to the countryside when the crisis broke in 2008 and China's exports slumped. Having farmland to go back to, many officials believe, kept the unemployed migrants from taking to the streets. As officials often say in China, "stability trumps everything."

Prospects for reform of the *hukou* system are only slightly better. Both Chengdu and Chongqing have been experimenting with this. They have declared that holders of rural *hukou* in the countryside surrounding these cities can move into urban areas and enjoy the same welfare benefits as their urban counterparts without giving up their land entitlements. This was an important step. Though the *hukou* divide is widely resented, peasants have often been reluctant to give up their rural status for fear of losing their land, as well as the added benefit in the countryside of being able to have two children rather than one. In effect, Chongqing and Chengdu have created a new class of urban residents who enjoy the best of both worlds. But grand plans for *hukou* reform have fallen by the wayside before as officials tot up the price. The cities of Guangzhou and Zhengzhou abandoned reform efforts several years ago because of worries about the cost.

Chongqing's plans are ambitious. Local officials estimate the cost of converting 3m people at around 200 billion yuan ($30 billion). But the municipality says it wants to double the number of urban *hukou* holders by turning 10m of its rural citizens (some of whom already live in urban areas) into card-carrying urbanites over the next ten years. It has made a rapid start. Since it relaxed its policy in August last year it has given urban *hukou* to more than 1.7m people. There are conditions: they must have been working in urban areas for at least three years, or for five years if they want to transfer their *hukou* to the centre of Chongqing.

The reform remains only partial. The benefits of being a Chongqing urbanite still cannot be transferred to any other part of the country. And if implementing such measures nationwide means raising more taxes, urbanites will dig in their heels. Local governments "don't really have the incentives and they don't have the resources" to encourage greater integration of migrants into urban life, says the World Bank's Mr Kuijs.

Although Chinese officials define the population as being already nearly 50% urban, the number of urban *hukou* holders is only around 35%. Zhang Zheng of Peking University says many of those who have moved to urban areas in recent years are wrongly seen as permanent migrants. Having reached their 30s or 40s, when they can no longer do mind-numbing, fast-paced and finicky work on production lines, they will often go back to the countryside. Late last year the National Bureau of Statistics asked rural *hukou* holders in the north-eastern province of Jilin whether they wanted to switch to urban status. "The results were surprising," one of the bureau's researchers wrote. The majority said no, and most young people who had moved to urban areas said they wanted to go back to the countryside when they got older.

For the past two decades or more, urbanisation in China has come relatively easily. As the country proudly claims, slums and shantytowns are rare compared with other developing countries. But ensuring a continuing net inflow of migrants into the cities as the youngest cohort shrinks will mean giving workers from the countryside more incentives to stay permanently (such as affordable housing and schooling). More money is being spent on these, but not yet enough. Too much responsibility is devolved to local governments that usually try hard to shirk it.

Cities say they welcome migrants, but some find roundabout ways of keeping them from settling. Beijing recently launched a set of extraordinary measures to tame property prices and ease traffic congestion that included all but banning migrants (one-third of the city's population) from buying homes or cars. In the name of improving safety, it has started closing down basement dwellings where migrants (known as the rat tribe) often live. China says it wants urbanisation, and it certainly needs it. But even as some obstacles are removed, new ones spring up.

from the print edition | Special report

The Economist

Special report: China

Deng & Co

In both town and country, clans are as important as ever

Jun 23rd 2011 | from the print edition

YANTIAN IS STILL called a village, but these days it is an urban sprawl on the outskirts of Dongguan, a southern Chinese city famed for its labour-intensive factories and sleazy nightlife. Almost all of Yantian's inhabitants are migrants from other villages: young men and women whose toil helped create an industrial boomtown in a former expanse of paddyfields. As migrants, almost all of them are in effect shut out from the best schools and hospitals, as they are from local politics. Yantian is ruled by the Deng clan.

Critics of the *hukou* system often see it as a form of discrimination against people from rural areas by a privileged class of urbanites. But it is a problem for migrants of any kind: from big city to big city, from smaller towns to bigger ones or, as for most of Yantian's residents, from village to village. The OECD noted in a report last year that wage differences between cities in the same Chinese province are much bigger than in OECD countries. It said this was due to distortions in the labour market caused by barriers to migration between cities, not just between rural and urban areas.

In Yantian, the "real" villagers are those who lived there before it began its industrial transformation a couple of decades ago. The descendants of such people, no matter where they are born, are also included. As is common in rural China, most of Yantian's original inhabitants belonged to one clan, in this case the Dengs. Today there are 3,000-odd of them, out of a population of around 100,000. They enjoy the dividends of Yantian's wealth in the form of land rent: tens of thousands of yuan per person a year. A Deng can live a comfortable life on that without lifting a finger. Every factory has to appoint a recognised Yantian villager as a "manager" to handle liaison with local officials, so there are plenty of sinecures for Dengs who want them.

The Dengs have celebrated their fortune by building themselves a grand ancestral shrine on a hillside overlooking the village. The ornate complex, opened in 2005, includes a pavilion dedicated to Deng Xiaoping who they claim was descended from another branch that linked with theirs half a millennium ago.

Chinese officials like to boast that the country is developing village-level democracy. The law was changed last year to allow migrants to vote in their adopted home, but the village still has to agree. The Dengs have not. So it was no surprise that when the Deng who had been village chief for 30 years stepped down in April, he was replaced by another Deng.

Hereditary city-dwellers often pour scorn on rural clannishness, but Chinese cities are in some ways Yantians writ large. Urban Chinese are just as reluctant as the Dengs to share their wealth more widely.

from the print edition | Special report

Government's role in industry

The long arm of the state

The government is flexing its muscles in business

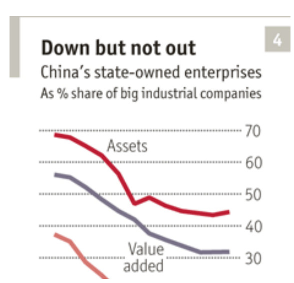
Jun 23rd 2011 | from the print edition

Himin got a leg-up

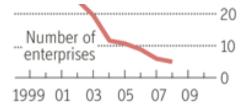
ONE OF THE privileges that urban *hukou* holders enjoy is access to jobs in the state sector in the cities where they were born. In the late 1990s such work might have sounded precarious as China closed down or sold off thousands of state-owned enterprises (SOEs), throwing millions out of work. But those SOEs that remain are giants: 121 controlled directly by the central government and thousands of others run by lower-level authorities. Chinese students used to aspire to a job with a foreign company. Now they are more likely to want one with an SOE.

This may seem an odd choice, since the dynamism in China's economy is mostly generated by non-state firms. From 1999 to 2009 the state's share of industrial output by value fell from 49% to 27%, according to a recent report by Unirule Institute of Economics, an independent think-tank in Beijing. In 1999 government-controlled firms owned 67% of industrial capital; a decade later their share had fallen to 41%. But in the industries that pay the highest salaries, state firms dominate.

A new shorthand has entered common parlance: *guojin mintui*, meaning the state [sector] advances and the private retreats. It seems to suggest that the state sector's share of the economy is growing, which it is not; non-state businesses are in fact prospering. But the government has been muscling in on business in a variety of ways. It has been tightening its grip on some industries it considers "strategic", from oil and coal to telecommunications and transport equipment. It has been devising market-access rules that favour state firms. And to the chagrin of private businesses, it has allowed state companies to remain active in a surprising range of palpably non-strategic sectors, from textiles and papermaking to catering. In recent years property development has become a lucrative sideline for government businesses. "The tentacles of state-owned enterprises extend into every nook where profit can be made," writes Zheng Yongnian of the National University of Singapore.



Of 42 mainland Chinese companies in the *Fortune* 500 list of the world's biggest firms in 2010, all but three were owned by the government. Carl Walter, a Beijing-based investment banker, said in a recent book that getting as many companies as possible into that select group was a matter of deliberate policy. China's own list of the 500 biggest Chinese companies spans 75 industries. In 29 of these not a single private firm makes the grade and in ten others they play only a minor part. The government-owned enterprises in these 39 state-dominated sectors



Source: World Bank

control 85% of the total assets of all the 500 companies in the list, according to researchers from the China Enterprise Confederation which compiled it. In 2010, 75 of the confederation's list of the 100 biggest publicly traded Chinese firms were controlled by the government.

Some Chinese economists worry that the government's response to the global financial crisis will bolster state enterprises and their bad habits at a time when they urgently need reforming. As the confederation's researchers put it, much stimulus spending has involved "swapping from the left hand to the right hand": the state lending to the state. "We do not do privatisation," declared the head of China's parliament, Wu Bangguo, in March, ignoring the fact that China had done a lot of it only a few years earlier. In the banking sector, says Yao Yang of Peking University, the government has been increasing its dominance in the past couple of years. Many Chinese economists call for interest-rate reforms that would allow banks to offer higher returns on household deposits (real interest rates are often negative). But banks do not want to lose the profits they make from the wide spread between government-controlled deposit and lending rates.

Unirule noted that the profits of state-owned industrial companies had increased nearly fourfold between 2001 and 2009. But their average return on equity was less than 8.2%, whereas that of larger non-state industrial enterprises was 12.9%. Factor in the low cost of borrowing enjoyed by SOEs and their access to land at below-market prices, the report said, and their real return on equity between 2001 and 2009 was minus 1.47%. They are, in effect, destroying capital.

Not pulling their weight

There are far better uses for their excess profits. Homi Kharas and Geoffrey Gertz of the Brookings Institution, a think-tank in Washington, DC, argued in a book published last year that if state-enterprise profits were used to help the government reduce all workers' social-insurance contributions, which currently make up about 35% of the remuneration of those in formal jobs, "China's middle class, most of whom are salaried workers, would instantly grow." The government has been requiring state firms to pay dividends since 2008, but many Chinese complain they are not offering enough and the money is being used to help state enterprises. The highest rate, paid by the most profitable ones, including the telecommunications, energy and tobacco industries, is 15% of post-tax profits—still very low compared with payouts by state firms in other countries. Even some official media have joined in the state-enterprise-bashing. A commentary on a government news website said they had "not played a positive role in improving social harmony".

Some foreign businesspeople complain that market-opening measures initiated in the 1990s and early 2000s have run out of steam. Many saw China's accession to the WTO ten years ago as a great impetus for reform. But when the country reached the end of its transition period in 2006, its will faltered. Many foreign companies still report doing good business. But especially since the global financial crisis, the government has been widely accused of twisting rules in favour of its state-owned or, sometimes, private-sector favourites. In a forthcoming book, "China's Regulatory State: A New Strategy for Globalisation", Roselyn Hsueh of Temple University says China's strategy of "economy-wide market liberalisation and sector-specific reregulation" has enabled the country to "retain an upper hand over foreign forces even in a more liberal environment".

Local governments sometimes play a decisive role in determining which firms succeed and which fail. Take Himin, a manufacturer of solar water heaters based in the city of Dezhou in the northern province of Shandong. Himin is a private company, but it is the local government's champion. Together Himin and the government have devised a branding strategy for Dezhou as China's "solar city". The government has helped Himin to grow by requiring apartment buildings to be equipped with solar water heaters and by subsidising solar-heated bathhouses in villages. This leg-up has been crucial. The firm says it is now the world's biggest manufacturer of solar heaters. In turn, Himin has been crucial to the success of Dezhou's leaders, who last year hosted a big international conference on solar energy—in a 200m yuan solar-powered conference centre built by Himin.

Himin knows how to curry favour. In 1998, before it became fashionable, it set up a party branch whose work so impressed the leadership in Beijing that a member of the ruling Politburo paid it a visit. Himin's rewards for good behaviour include a seat on the national legislature for Huang Ming, the company's founder. One of the party cell's benefits, says an official account, has been to establish a "channel for understanding the direction of [government] policy".

Innovation by all means

Far more worrying to foreign businesses is a more overt form of government intervention involving support for Chinese companies that develop new technologies and discrimination against their foreign competitors. Complaints about this began to surface five or six years ago but have been growing much louder in the past two years. James McGregor of APCO Worldwide, a consultancy, described the government's strategy in a report last year as a "massive and complicated plan" to turn China into a technology powerhouse by 2020 and a global leader by 2050. He said it was "steeped in suspicion of outsiders" and constituted "a blueprint for technology theft" on a large scale.

This scheme to encourage what the government calls "indigenous innovation" focuses on seven "strategic" industries, from alternative energy and low-carbon-emitting vehicles to information technology. *First Financial Daily*, a Chinese newspaper, reported that investments by these industries could amount to as much as $1.5 trillion over five years, of which the state is likely to contribute 5-15%. Mr McGregor says the scheme involves creating new Chinese technologies on the back of foreign ones supplied by companies eager for a share in the government's massive spending. Some Chinese scientists have complained about the likely waste involved in state-directed R&D, but the party loves big projects too much to listen.

Foreign businesses in China have fought most bitterly over a new government procurement policy, launched in 2009, that favours products listed in catalogues of "indigenous innovation" technologies. They feared that the new regulations would shut them out of a multi-billion-dollar market. Under considerable international pressure from Western governments, Chinese leaders relented, promising that products supplied by foreign-invested firms in China would be treated like those of Chinese businesses. But in a recent report the American Chamber of Commerce in Beijing said several regulations still needed to be changed before these pledges could be implemented. In a survey a quarter of its members said they were already losing business because of "indigenous innovation" policies and 40% expected business to suffer in the future. Most of the American high-tech companies in China covered by the survey expressed concern.

China's state-sector reforms in the 1990s went for the low-hanging fruit. A decade ago angry workers were easily cowed into submission by police or bought off with handouts. But any further reform would affect the interests of people in the top echelons of the party as well as their families, who have extensive connections with state-owned firms.

Zhu Rongji, the former prime minister whose reforms obliterated many of China's state-owned firms in the late 1990s, has also gone on the attack. In April he made a rare public appearance at his alma mater, Tsinghua University. He handed over copies of a four-volume collection of his speeches, due to be published later this year, and pointedly invited readers to "make comparisons with the situation today". To his supporters, the present looks grim.

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Special report: China

Demography

Getting on

The consequences of an ageing population

Jun 23rd 2011 | from the print edition

THE CLIENTELE OF the Le Amor retirement home in the Fragrant Hills of western Beijing are no ordinary folk. Staff boast that one of them taught President Hu Jintao when he was at university. Another is the descendant of a nutritionist who worked for the Empress Dowager Cixi, China's last great imperial ruler. A third is a former senior official in the party's top anti-corruption body. By the grim standards of such homes in China, it seems they are being treated well. If they wish, they can rent a suite of rooms, including one for a live-in servant. All rooms have an emergency button.

The home's director is coy about how she secured such a desirable rural location for her $10m venture, away from the city's downtown smog. Le Amor is one of only a handful of privately run retirement homes in the capital aimed at the well-to-do. Looking after the elderly is a business in its infancy in China, where that task usually falls to the offspring, if any. But Le Amor's market has very attractive prospects.

Over the next few years China will undergo a huge demographic shift. The share of people over 60 in the total population will increase from 12.5% in 2010 to 20% in 2020. By 2030 their number will double from today's 178m. The dependency ratio—the number of people of non-working age, both young and old, as a proportion of those of working age—will bottom out between 2012 and 2015 at an exceptionally low level before rebounding, says a report by the Chinese Academy of Social Sciences. Put another way, China's "demographic dividend"—the availability of lots of young workers—which helped fuel its growth will soon begin to disappear. The overall population will start to grow faster than that of working age. One trigger for this could be a sharp economic slowdown. Many Chinese have recently become familiar with the "Lewis turning point", named after a 20th-century economist from St Lucia, Arthur Lewis, who said that industrial wages start to rise quickly when a country's rural labour surplus dries up.

One way this will show up is in a proliferation of places like Le Amor. A lot of schools will close down. Wang Feng of the Brookings Institution notes that China's primary-school enrolment dropped from 25.3m in 1995 to 16.7m in 2008. Revoking the one-child policy

Watching the dependency ratio grow

would probably not make a big difference. Chinese couples have small families mainly because children are expensive, Mr Wang argues. China's rapid ageing, combined with a shrinking labour force, will "fundamentally reshape the Chinese economy and society", he suggests. In the next decade the number of people aged 20-24 will drop by 50%, Mr Wang predicts.

Optimists believe China still has several more years before the economic impact of an ageing population becomes apparent. China's commerce minister, Chen Deming, said in March 2010 that the country could still enjoy another decade of "demographic dividends". In a report last year Morgan Stanley pointed to 80m-100m surplus labourers in the countryside who could be employed in urban areas (although as this special report has argued, that might not be easy). It also expressed optimism about continuing productivity gains from rising levels of education and technology use.

In search of cheap young workers

Still, the redrawing of China's economic map is unmistakable. A decade ago, impoverished migrants gathered outside factories in cities like Dongguan, desperate for work. Now Dongguan's streets are full of banners and notices advertising jobs. Wage rises are beginning to accelerate. According to Stephen Green of Standard Chartered, they have risen by 9-15% this year in the Pearl River Delta around Dongguan. Part of the increase is government-driven. Local authorities have been raising minimum wages, and the new five-year plan calls for increases averaging 13% annually, nearly twice as fast as the target for GDP growth. But the main reason is a diminishing labour supply, helped in the delta by an uptick in labour activism. A local academic says that a strike at a Honda car-parts factory last year provoked more than 200 copycat strikes and protests.

Manufacturing is beginning to move inland to areas where labour is more plentiful and cheaper. Chongqing has been a big beneficiary. Morgan Stanley says the city is turning into the largest laptop manufacturing base in Asia. Its electronics industry is expected to create hundreds of thousands of jobs. Foreigners invested $6.3 billion in Chongqing in 2010, up by 58% on the year before.

Meanwhile, local governments across the country will have to cope with a fast-rising population of retired people whose pensions, if any, will have to be paid for by contributions from a shrinking working population. The central government has been trying to help, introducing a rural pension scheme that is due to cover the whole of the countryside by 2020. In rural areas the dependency ratio will rise far more steeply than in cities as young people move out and the elderly stay behind. But again money is a problem. As with schools and medical services, the central government makes the plans but leaves it to local governments to put up the lion's share of funding.

In the cities decent pensions are almost as rare, except among workers in the privileged state sector. In 2008 only 17% of migrants in urban areas were enrolled in any pension scheme at all, the government admits. Young urban couples, many of them without siblings, will find themselves with four parents to look after and will themselves have only one child (known as the 4-2-1 phenomenon). If they are sensible, they will save hard to prepare for such a future, which will not help the government's efforts to shift China towards more consumption-led growth.

A big increase in the retirement age is overdue. In practice this is now around 56. But the official age of 60 for men and 50 for women (55 for civil servants) has not changed since 1951, when average life expectancy was 46 compared with today's 73. Like their counterparts in the West, many workers groan about having to plod on for longer. Online polls, which are likely to reflect the views of younger people, have found strong opposition to any rise in the retirement age. Many fear that it could make it even harder for university graduates to find jobs (last year 6.3m students graduated from Chinese universities, up from 1m in 1999, so competition is fierce). When French workers went on strike last year over plans to raise their retirement age, officials in China hastily denied reports that they were planning to do anything of the sort. The people's will is almost as much of an obstacle to reform in China as the party's.

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Special report: China

Ideological battles

Universalists v exceptionalists

A mighty contest whose outcome will determine China's future

Jun 23rd 2011 | from the print edition

FOR A PRINCELING and former chairman of a state-owned company, Qin Xiao is far from typical. Instead of retiring quietly or taking up a party-funded sinecure, the gaunt one-time apparatchik has emerged in recent months as the standard-bearer of a liberal force in Chinese politics that refuses to be subdued by chest-thumping supporters of the "China model". He believes there is no such thing, only "universal values".

Mr Qin caused a stir in July last year when, in a speech at one of China's most prestigious universities, Tsinghua, he accused the China modelists of trying to replace enlightenment values of democracy, freedom and individual rights with "Chinese" ones, such as stability and the interests of the state. He was then very close to retiring from China Merchants Group, where he had held a job of ministerial rank bestowed on him by the party leadership. Since then he has not kept quiet.

Mr Qin continues to head a think-tank, the Boyuan Foundation, which he set up in 2007 along with He Di, an investment banker, who is also from one of the party's blue-blooded families. "China needs someone to stand up and speak," Mr Qin said in an interview published in May by an outspoken newspaper in Guangdong Province, *Southern People Weekly*. The Arab revolutions showed that no matter how well a country's economy performed, "people do not accept dictatorial, corrupt government." He is not alone in elite circles in expressing such views. Wang Changjiang, a senior scholar at the party's top training academy for cadres, lamented in December that there was a "phobia of political reform" in China.

In recent months the battle lines in China's politics have become clearer. They are drawn between universalists, who believe China must eventually converge on democratic norms, and exceptionalists, who believe that China must preserve and perfect its authoritarianism. For now the second group has the far stronger hand. The views of people like Mr Qin surface occasionally in China's handful of liberal newspapers, but hardliners in the party's mighty publicity department ensure that most media stick to a more conservative line. Remarks made by the prime minister, Mr Wen, last summer on the importance of (ill-defined) political reform were downplayed by mainstream newspapers in Beijing. Mr Wen is one of very few Chinese leaders who have clearly spoken in favour of the idea of universal values.

Liberals are particularly worried that the exceptionalist camp is also attracting the most ardent nationalists, who often claim that the West is trying to undermine China's achievements and keep the country from its rightful place as a great power. Zhang Weiwei, a scholar and proponent of Chinese exceptionalism, wrote in March that China's evolution was "as if the Roman empire had never collapsed and had survived to this day, turning itself into a modern state with a central government and modern economy, combining all sorts of traditional cultures into one body and with everyone speaking Latin."

David Kelly at Sydney's University of Technology says the vocal nationalist left is having a similar effect on China's Communist Party as America's tea-party movement is having on the Republican Party: pushing it towards inward-looking conservatism. Statism is becoming the new ideological fashion, emphasising the paramount interests of the nation over the individual and the importance of government in guiding the economy. But many Western officials privately worry about the effect on China's behaviour of a confluence of nationalism, rapidly growing military capability and deeply held feelings of victimhood. Chinese diplomats continue to stress the importance of a "harmonious world" and decry the use of military force to resolve disputes. But in the past couple of years ascendant hardliners have pushed the foreign ministry, which had been relatively weak at the best of times, to adopt a more assertive, sometimes aggressive, posture. David Shambaugh, an American scholar, wrote in the *Washington Quarterly* that 2009 and 2010 "will be remembered as the years in which China became difficult for the world to deal with".

Don't pull the dragon's tail

This prickliness is partly explained by political uncertainty in the build-up to the leadership transition. No Chinese official who aspires to the top would want to be seen as weak in the face of any foreign slight. If China's economy begins to sputter in the coming years, the country's leaders will be all the more tempted to play to the nationalist gallery.

The Americans draw comfort from the fact that at least Taiwan has receded as a possible target of this. China has been more relaxed about the island since the election of a China-friendly president, Ma Ying-jeou, in 2008. Mr Ma and his Kuomintang party face fresh presidential and parliamentary elections on January 14th next year, but the opposition still has a lot of catching up to do.

A senior Chinese official compares China to Yao Ming, a basketball player and one of the country's most famous sporting heroes, when he was a teenager. At the age of 15 he was taller than everyone else, she says, but he was still only 15. Likewise, China is still maturing as a power and learning to cope with the world's rapidly growing expectations of it. This is an endearing image, but China has a problem that never troubled Yao Ming: a brooding animosity towards competitors that erupts occasionally into self-destructive rage. Spats last year with Japan and South-East Asian countries over maritime territorial issues badly tarnished China's image in the region.

As China becomes ever more engaged with the rest of the world, dealing with problems ranging from climate change to piracy and global financial security, the message it still conveys to its own people is that the West is implacably hostile to the country's rise. A Chinese patriot, the party is saying, must always be on guard against Western efforts to break up the country.

Here we go again

Such thinking is in abundant evidence at the National Museum overlooking Tiananmen Square. After a refurbishment lasting more than three years and costing some 2.5 billion yuan, the museum reopened in March to much fanfare. But one of its main attractions, an exhibition called "The Road to Rejuvenation", suggests that although the packaging is new, the content is much the same as before. What the party is telling its citizens is that the country is still recovering from the terrible wrong wrought by one-time imperialist powers.

The visitor walks through room after room recalling the depravities of foreign invaders in the 19th and 20th centuries who, as one notice puts it, "descended on China like a swarm of bees, looting our treasures and killing our people". There is a giant picture of Japanese troops butchering civilians in north-east China in 1894, painted two years ago; a large map that lights up to show areas under foreign domination in the 19th century; and a section called "cultural invasion and pillage".

There are huge gaps in the exhibition's coverage of the Mao period, when tens of millions died of hunger and millions from political persecution. It does not mention the Tiananmen upheaval of 1989 in which security forces killed hundreds, perhaps thousands. Instead, the visitor moves into a huge room brimming with cold-war imagery: China's accomplishments in space, its Olympic successes and a diorama of military hardware with a video display of marching troops.

Such ossified official thinking contrasts with a lively debate among Chinese intellectuals about where the country should be heading. In books, articles and blogs, some say that an era in the post-Mao history of China has ended. More than 30 years of reform, initiated by Deng Xiaoping, have transformed the country both economically and socially. Now, they say, it is time to focus on the unfinished business, that of transforming the country's politics. Deng himself stressed the importance of political reform, but the Tiananmen Square protests put an end to any prospects of taking it further. Given a fast-growing middle class, many liberal scholars argue, the country cannot afford to put it off any longer.

Many Chinese fret that any move towards more democracy would be doomed to failure because a politically empowered peasantry would simply make a mess of it. It is also often argued that democracy and Chineseness do not mix. The bloody mayhem of the Cultural Revolution is held up as an example of what can go wrong. China's leaders insist that political reform is still on the agenda. They point to some recent movement: occasional consultations with the public over the drafting of laws, a bit more openness about government budgets, and experiments with reform inside the party itself to allow a modicum of democracy in the selection of lowest-tier party officials. There is little sign that the new middle class is aching for more just yet.

But the next few years could see that middle class becoming more demanding. The internet will play a big role in this. The outgoing leadership has tried to tame it, but it remains a powerful tool for the disaffected in China, helping them to mobilise and share their grievances. One trigger could be a sharp economic slowdown. But even if the pace of growth eases gently, as many predict it will, the government will find itself under growing pressure from the less well off to distribute wealth more effectively.

That will require new taxes. One of these could well be a levy on property. Chongqing and Shanghai have recently begun very cautious experiments with such a tax, aimed in part at reducing local governments' dependence on money raised by taking land from peasants. But so far it affects only a tiny number of people in these places. A property levy on a broad swathe of the middle class would stir demands for a say in how their tax money is spent. For now the party would rather deal with angry underdogs than with an embittered bourgeoisie.

The tenure of China's outgoing leaders coincided with the rapid emergence of a new property-owning class that had barely existed until the late 1990s. The new leaders who will begin to take over next year will have to grapple with the political consequences. Their preference is likely to be more of the same: granting economic concessions but ceding nothing on politics. This could well result in even greater instability if the economy were to run out of steam.

China's current leaders may not agree that this is yet a *shengshi*. But when they took over in 2002 they set themselves the task of building what sounded rather like one. By 2020, they said, China would become a "well-off society in an all-round way". Some of the economic targets they set were easy: quadrupling GDP from a 2000 baseline and, later, quadrupling GDP per person by 2020 (real GDP had grown 2.7 times in yuan and more than fourfold in dollars by 2010).

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But there is a lot of hard work still to do on some of the political and environmental goals: "better" democracy at the grassroots and greater "harmony between man and nature". Democratic reform is on hold and the environment is a mess. The leadership has recently begun to talk about a new target: boosting public "happiness" rather than just GDP. In a decade fraught with economic and political perils in China, that will be the hardest goal of all to achieve.

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