

ECONOMY AND SECURITY, OR COLD WAR TWO

The times are peaceful and yet wars are on. We have quite some regional conflicts and local clashes erupting, but it's a lesser evil than a great global explosion. Luckily disputes between the titans of the world have been bloodless to date. There are no saints here when it comes to intentions and acts as none of the three contemporary most powerful actors on the political and military scene – the United States, China and Russia – is free from guilt. All three are flexing their muscles, which ruins the international relations and reeks of a new cold war, while doing harm to economic cooperation and to efforts to create a more inclusive version of globalization.

Unfortunately, we can already speak of Cold War Two. That's how I referred to the present state of affairs several years ago, on the occasion of the 100th anniversary of the start of World War One. Back then I wrote: “One hundred years ago a war was unleashed. It lasted for almost four and a half years, millions of people were killed. In the beginning nobody realized it would be a world war, but it quickly turned this way. In the 1920s and 1930s, it was referred to as the Great War. It took another war, breaking out 25 years later, to get the previous one, that of 1914-18, the name of World War One. Soon after World War Two, that of 1939-45, was over, the Cold War was unleashed. This was done by the West in confrontation with the East, which was defeated decades later. It even so happened that after 1989 the ‘end of history’ was announced on that occasion. How prematurely...

After only generation of more or less peaceful times, Cold War Two was started. Indeed, the one of 1946-1989 will be referred to by historians as Cold War One. It was won by those who started it: the West. Now the West, too, is getting Cold War Two started. But it won't win this one. Neither will the East win it. It will be won by China, which is doing its own thing, most of all consistently reforming and developing the economy, whose international

position is strengthening with every year that passes. A few years, or over a decade from now, when both US hawks with their allies, and those from Russia, get weary of their cold war imprudence, China will be a yet greater superpower; both in absolute terms and relatively, compared to the USA, European Union, Russia... Also the position of other countries, including the emancipating economies refusing to be dragged into another cold war turmoil will be relatively better.” (Kolodko 2014). Well, that is exactly the goal: not to get dragged into it.

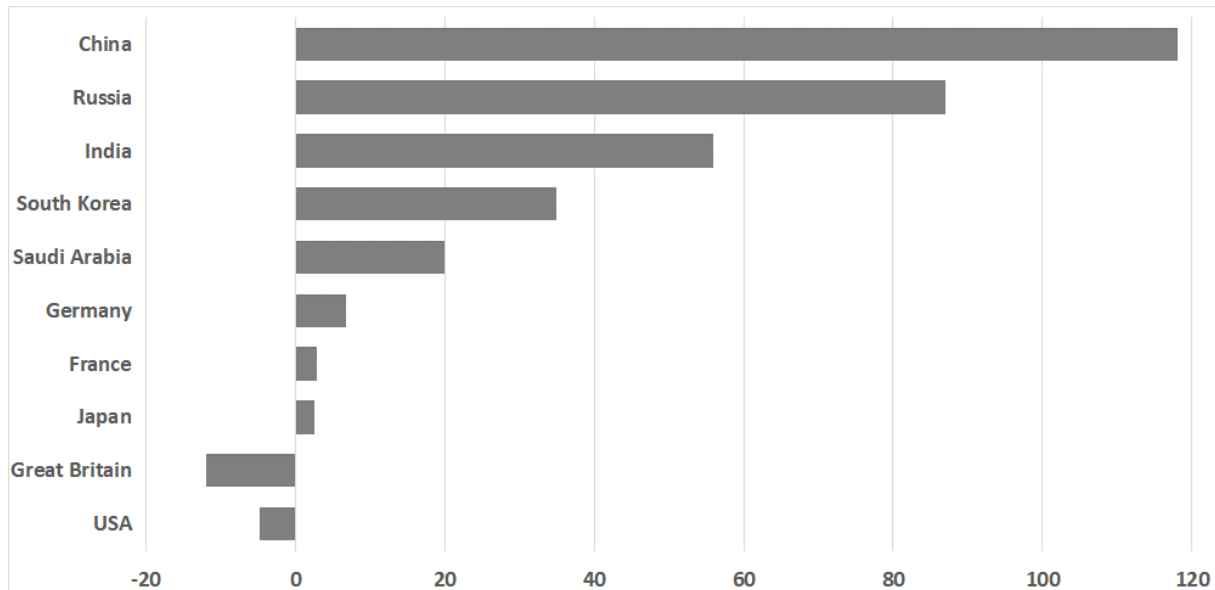
The richest country of the world, the United States, instead of increasing its aid expenditure, mindful of co-creating economic foundations for peaceful development, cuts it to have more funds for armament. Even though the level of the latter is already very high, the US Senate is pushing for a further increase of 80 billion in 2019 and 85 billion in 2020 (BBC 2018b). As at 2018, the expenditure is set at 692.1 billion dollars, which represents an exponential, 18.7 percent growth compared to previous year. At the same time Russia is reducing its military expenditure by 9.2 percent, cutting it to 2.77 trillion rubles (42.3 billion dollars) (Bershidsky 2017). This is surprisingly little compared to the USA, but relatively much more because while the USA earmarks “only” 3.3 percent of its budget to defense spending, in Russia it’s ca. 5 percent. While the country’s president Vladimir Putin justifies the military spending cut with the need to increase expenditure on healthcare, education, science and culture (which should be applauded), his detractors are quick to point out that it’s only a short-term political marketing gimmick applied before the presidential election to be held in the spring of 2018 (which should be rebuked).

In China, the indicator describing the ratio of military spending to national income is nearly half of that of the USA and stands at 1.9 percent of GDP, but is quickly growing. In absolute amounts, Chinese military spending is merely a third of the American one, ca. 230 billion dollars a year, but let’s remember that there is also expenditure incurred which is in fact military though it’s posted as

items other than “defense”, for example some research and development spending which evidently serves the army is realized in the “science” department. Let us add that this is not Chinese specificity; others do the same.

Hence, the Chinese military spending is still a small fraction of the American one, but it must be emphasized that while the USA, despite the recently greatly increasing outlays, is still spending less than ten years ago, China is spending nearly 120 percent more. It’s little consolation that others among the countries with the world’s largest military budgets have increased their spending to a much lesser degree.

**Diagram 1: Changes in major military powers' defense spending
(percentage increase in 2007-2016)**



Source: Own compilation based on the data of Stockholm International Peace Research Institute.

Analysts in the field highlight the predominance of spending on defensive weapons and facilities in all of China's defense expenditure. One of the major tasks in this area is to develop the sector manufacturing weapons that, in the event of a conflict, would push away the US military power as far away as possible from the Chinese shores, preferably in the most remote Pacific areas. So the point is to move the enemy army away from one's own shores rather than bring one's own closer to somebody else's shores. This strategy is known in the military jargon as *anti-access/ area denial*, A2AD. This, by no means, prevents developing various types of offensive weapons, including very sophisticated products such as drones, that China has started exporting on an increasing scale. It is far behind the USA and Russia, as well as the United Kingdom and France in that respect, but it is said that, with products having the 75 percent capacity of the Western ones, China sells them at 50 percent of the Western price (Marcus 2018). To many buyers it's a great deal so, sadly, the arms race is again gaining impetus.

It is all the more worrying that the US President Donald Trump, rather than looking for conciliation and creating new channels for good international and global cooperation, a year since taking the world's still most important office, announces that China and Russia are not so much the United States' partners but rivals. It comes as little surprise then that even such an opinion-leading weekly as the Anglo-American "The Economist" cautions against the growing threat of a conflict between superpowers erupting. It was no coincidence that it did so in the issue published during the annual World Economic Forum in January 2018 to further raise the adrenaline level of politicians and business people, financiers and bankers, academics and media representatives meeting in Davos (Economist 2018a). So do we have anything to fear? And if so, who and what is the threat?

In many parts of the world, there's especially a lot of scaremongering about China, its growing power supposedly threatening the peace of others. The country is feared not only by some from the same region, not only by the immediate neighbors like Japan or South Korea, India or Pakistan, but also in more remote part of the world, including the West, especially the United States and some European countries succumbing to Sinophobia. In others, on the contrary, China's expansion inspires some hope for a more balanced world, a new global order where a counterbalance emerges to the dominance of the West with its eyes fixed on its own interests only.

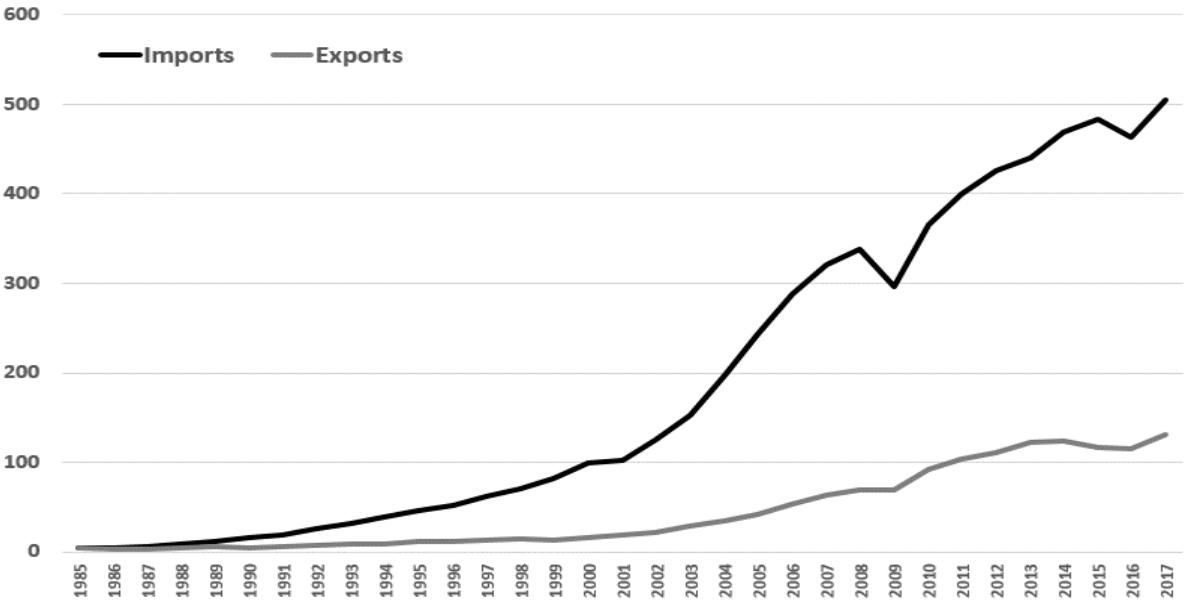
The anti-Chinese narrative is especially becoming stronger among the US establishment and some, notably conservative, media and part of social science community. Excessive irritability is certainly undesirable and harmful in the business sphere, though it can be justified by situations where capitalists and executives managing their companies get frustrated by their inability to keep up with foreign competition, which is often identified with China. It's even worse if the ones losing their temper are politicians and lobbyists, also those linked to the media and the academic and research community.

What strikes me as something unheard of, for a long time, maybe since the last cold world, is the aggressive, more emotional than rational public attack (rather than a cold matter-of-fact criticism) of “The Economist” weekly, which entitled its cover story “How the West got China wrong”. It argues that the West “bet that China would head towards democracy and the market economy. The gamble has failed. (...) China is not a market economy and, on its present course, never will be. Instead, it increasingly controls business as an arm of state power. It sees a vast range of industries as strategic. Its “Made in China 2025” plan, for instance, sets out to use subsidies and protection to create world leaders in ten industries, including aviation, tech and energy, which together cover nearly 40 percent of its manufacturing.” (Economist 2018d). Well, it's a fact that China, rather than adopting the path of Western-style deregulated market economy, follows that of active economic interference, by running a well-oriented industrial policy, which, mind you, many western countries used to have in place, and some of them, for example South Korea, are still far from despising. If things were indeed as bad as persistently argued by those who are uncomfortable with the Chinese path because it makes life easier for the Chinese rather than for them, further considerations should be limited to searching for the answer to the question why this happened and what the implications are. However, reality is far more complicated.

Of course, the criticism of China is by no means unwarranted as its economic policy and systemic solutions oriented to improving the internal situation can be costly for others, who, under the current circumstances, are unable to keep up with competition. Irrespective of the structural inability to balance the US trade balance, which has been a major cause for anti-China resentments for some time now, there are also cases of China’s espionage activities in the US and other Western countries as well as various attempts to use soft measures to influence what goes on there. However, the Chinese could learn more about it from Americans than vice versa.

The US trade deficit is, first and foremost, the function of the country's weak and not competitive enough export offering rather than that of unfair Chinese competition, as Donald Trump and other Sinophobes would have it. The time has come to understand that the fundamental cause of uncompetitiveness of some US sectors is living beyond one's means, which is manifested, among other things, by employees' wages, managers' compensations and owners' profits being excessive. In an extended cost/benefit analysis, wages are the main factor determining the costs, which ultimately turn out relatively too high on the liberalized world market. However, having recourse to protectionist practices will not be of much use in the long run, and a verbal attack on China will be of no use at all. It only ruins the atmosphere, which is already far from great.

**Diagram 2: US-China trade in 1985-2017
(in USD billions)**



Source: Data of the International Monetary Fund.

When denouncing the truly immense surplus of the Chinese exports to the US over the American ones to China, the countries' bilateral relations are not given a comprehensive evaluation. Poland, for instance, has relatively, compared to its national income, a much higher deficit in its trade with China,

but it is able to balance it in total foreign trade, recording surpluses in other relations. Statistics tend to simplify the reality. It's a fact that in bilateral trade relations there are 12 times fewer dollars paid to Poland by China for its direct exports going there than for imports from China. At the same time, cars, whose components are manufactured in Poland, are a substantial portion of German exports to China. Cars are the top ranking item in the vast German exports amounting to USD 1.4 trillion, 6.4 percent of which go to China. Assuming that those German car exports contain, in terms of value, 10 percent of Polish automotive industry's products, the total amount is 30-35 billion zlotys (ca. 1.5 percent of GDP). Hence, if we conduct a comprehensive analysis, it turns out that the trade exchange with China creates a lot more jobs, income and budgetary revenues in Poland than it would seem on the surface of things.

The USA is unable to do that and constantly has a major trade deficit. In 2017, it amounted to 375 billion dollars in goods trade with China, with a total gap of 566 billion dollars. This fans the flames of rhetoric targeting China and some other countries, especially the neighboring Mexico, but it's still a far cry from the fever of McCarthy's time anti-Soviet aberration in 1950s. However, it's a fact that in Washington D.C. scaremongering about China is rife. "Chinese efforts to exert covert influence over the West are as concerning as Russian subversion" says Mike Pompeo, head of the US intelligence, CIA. "Think about the scale of the two economies (...). The Chinese have a much bigger footprint upon which to execute that mission than the Russian do." (BBC 2018a) It has to make us wonder if not worry when this comes from one of Washington's most influential politicians.

Quite contradictory pictures are being painted on the historic scale. On the first one, imperialism, that of Western, capitalist variety, is supposed to be replaced with another, the Eastern and "communist" one. A real perspective or an ultimate irrationality, because neither is there communism in China, nor is the country striving to dominate the world? On the second painting, China is

presumed to save the world from the rampant economic and environmental dangers as it has the exceptional capacity for long-term and comprehensive approach to problem-solving and is not selfishly focused on its interests only. The walls of our shared global house could be adorned with many more paintings that we could contemplate like in a gallery of eclectic arts.

Contrasting values, conflicts of interest, ambiguous situations, unclear intentions cause the same facts to be interpreted quite differently. While not a word of criticism was breathed on the occasion of Angela Merkel being appointed the chancellor of Germany for the fourth term in office, there was quite an uproar, when the provision of the Chinese constitution limiting the presidency to two terms was scrapped. Passing over the fact that the key position in the Chinese political hierarchy is the chairperson of the ruling single party, with the president having actually little say, some are inclined to decide, for this reason alone, that from that moment on, the current leader of China, Xi Jinping, who, mind you, has only started his second five-year term in office, becomes a lifelong dictator. Meanwhile, others emphasize it's the right move which, in itself, does not determine who exactly will be yielding power, but, if necessary, enables continuity in the sphere of long-term development policy leadership. And that's of crucial importance at a time when an increasing number of problems require a long-term approach.

While leaving the “dictator or strategist” antinomy unresolved (and ignoring that, theoretically, one can be both), it's worth emphasizing that sometimes the limit on terms in office of public officials, who are elected too often for too little time, is precisely what entails the short-term thinking and actions, with the obvious negative consequences with respect to the socio-economic development. This kind of short-termism, or shortened time horizon in which various alternative action scenarios are considered, surely is not characteristic of the Chinese policy; quite the opposite. Many a times this is what makes the Chinese way of steering the economy superior, because the

negative impact of political cycles on the economy, so typical of Western liberal democracy, does not occur in China.

In this beautiful democratic world of ours all kinds of referendums or elections keep taking place, in Greece or Italy, in the UK or in France, in Austria or the Netherlands, in Spain or Germany, whereas all is quiet in China... Somewhere in the faraway Brazil, the President was impeached, somewhere closer, in South Korea, the President was also deposed, in the South African Republic the President was forced to resign, whereas all is quiet in China... In North Africa and in the Middle East the Arab Spring compromised itself, whereas all is quiet in China... Even in the supposedly institutionally mature and economically advanced European Union, every now and then someone needs to be rebuked or removed from the position, whereas all is quiet in China... Well, at least relatively quiet.

China with its specific economic and political system developed over the last 70 years has become the focus of attention of many other catching-up countries. In a situation where the classical development economics failed, and fail it did (Easterly 2002 and 2006), to many an economist and politician – from Bangladesh to Senegal and Ecuador, from Asia to Africa and Latin America – the Chinese model that has proven itself in practice is worth an in-depth and critical observation as well as creative adaptation and application back home. China is a unique state, which, in just two generations, from 1978, when the gradual market reforms started, is changing its status from that of a *low income country* (as per World Bank's terminology) to *high income country*, which level it is estimated to reach already in 2024 (Hofman 2018).

When pointing to four fundamental differences between highly and poorly developed countries, or, looking from a different perspective, rich and poor countries, what is emphasized is the superiority of the former in terms of capital endowment, technological advancement, educational capabilities, human capital quality and the development level of modern infrastructure. In each of those

respects, China has made an immense quantitative and qualitative progress. In some respects it is even ahead of rich countries, especially when it comes to investors' disposable capital and some elements of hard infrastructure. Suffice to realize that three decades ago there were hardly 600 km of motorways nationwide, and now there are a hundred times more, ca. 60 thousand kilometers. While there were no high-speed trains at all, presently their network is 20 thousand km long (there aren't any in the USA). From this point of view, China is doing quite well and lags behind only slightly, if at all. Meanwhile, soft infrastructure is where the backwardness compared to the highly developed West is still visible.

Poor countries are poor mostly because they have not mastered the skills of administering the economy and regulating economic processes. Without those skills, the market alone is of little use; it is functional for a fair or a local market, but not for a greatly complex body that is national economy, and the society and state operating within its framework. Whoever has seen the liveliness and indefatigable energy of people on the streets of Dhaka or Lima or on the border of Nigeria and Benin, will undeniably acknowledge the laboriousness and enterprise of this human mass, but it's hard to see in this multitude of moving people and goods any sophisticated forms of organization, management, coordination, supervision, control. This may be enough when you trade in boxes of tomatoes or batteries for flashlights (imported from China, where else?), but not when it's about modern, highly complex, dynamic economic systems. What one needs there is an advanced level of administration and mature regulation, which is in chronic shortage in the poorest countries.

Shortcomings in the sphere of market economy institutions are one of the principal reasons for the poor condition of economies (Acemoglu and Robinson 2012). What is meant here is institutions in behavioral rather than organizational sense, or the rules of conduct, rules of the game in the economy, both those codified in the regulations of the applicable laws in force and those rooted in the

culture and customs resulting from practical experience (North 1990 and 2005, Kolodko 2004).

In centrally planned economies, there was definitely no shortage of administration and regulation; there isn't any in China, either. However, those institutions were centralized and hierarchized in nature and would quite often take a cumbersome and overly bureaucratized form. Coupled with the state socialism's typical tendency to favor hard industry, including arms industry, this was conducive to mobilizing funds and accumulating capital necessary for expansion, but the attendant high priority of production of means of production did not favor production of means of consumption. No wonder then that such superpowers as the Soviet Union (first) or China (later) were capable of organizing the production of a nuclear bomb and conquering space, but unable to ensure continued supplies of food products to their population.

China, setting the historical course for catching up with developed countries, radically diminished four of the differences setting it apart from rich economies and made a great progress in eliminating the institutional gap. This is achieved not only by actively adapting the institutions that prove effective in market economies of the West and modifying some of the earlier used methods of administration and regulation, but also by implementing its own original institutional solutions. Also here one can clearly see the importance of creative continuity and change management in economy reinstitutionalization. There is still much to be done and, certainly, when it comes to catching up with rich countries in the future, there is more to be done in this very field than in the sphere of physical and human capital accumulation, modern technologies and hard infrastructure. That's where one of the main chapters of the battle for the future will play out.

But... Exactly, there is no shortage of "buts". In the same way as there may be too little or too much cholesterol in the blood circulating in a biological organism, in a social economic circulation, too, with respect to production and

storage, distribution and sale, savings and investments, banking and finance, enterprises and state, there may be too few or too many institutions. Moreover, just like there is good and bad cholesterol, there are also good and bad institutions. Thus, not every institutional change promotes growth and economic equilibrium, or contributes to economic development. Sometimes it's the opposite. If administration, intervention and regulation do not serve to accumulate capital and optimize its allocation, but to help bureaucratized and corrupt state apparatus, those notorious "officials" and "political elites", to suck out some fruits of collective economic activities, then it's like bad cholesterol. An organism can also suffer when there is deficiency of good cholesterol, or when there's a deviation in the opposite direction. This happens if the weakness of the state and its regulatory functions allows unscrupulous business people, the infamous "capitalists" to prey on the results of somebody else's work.

In contemporary China, such institutional risk is abundant as many issues are not yet finally settled, if, at all, they could be ever decided for good. Considering the economic system is *in statu nascendi* and undergoing many changes in the sphere of economic regulation, which, in many cases can cause over-regulation, on the one hand, and under-regulation, on the other, it's hard to say which of the two currently poses a greater threat in China. Both should be constantly watched out for.

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