



Address to the Annual Calgary Dinner of the C.D. Howe Institute

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Thank you. I am very happy to be back in Calgary, and to be back with the C.D. Howe Institute. As I will try to make clear in my remarks, and as you already know well in any event, Calgary is in many ways the center ring for all the changes, the challenges and the opportunities that China's dynamic emergence is generating across Canada. And I couldn't be with a more informed, interested or influential audience.

I should start by explaining that it is somewhat unusual for a former public servant – a role that I have had for all of 2 weeks – to be standing in front of a microphone. It isn't a role that I had originally imagined for myself. There is a school of thought that says that retired Canadian officials should be *not* seen and *not* heard. That's a tradition, by the way, that I encouraged the ambassador *I* replaced to adopt.

Imperial Chinese officials embraced this doctrine, too. They used to retire to their gardens – my favourite is the Garden of the Humble Administrator in Suzhou – for what the writer Colin Thubron described as “stillness after the stress and pomp of a government career.”

I was thinking about disappearing, too. It wasn't stillness, or even gardening, that I was looking for, more the chance to take the time reflect on what I have been doing, and what it means.

But as the date of my departure from Beijing approached, I called to mind a consideration that had loomed large for me back in late 2008 and early 2009, when I was still working on Afghanistan. The opportunity to go to China was in the wind. I had accomplished much of what I set out to do as part of the team implementing the recommendations of the Manley Panel. But I was reluctant to leave a file of national importance. I only made my decision for Beijing after reflecting on the fact that, in many ways, having the chance to play even a small role in getting the relationship with China on a sound footing, was a challenge of equal worth and merit.

We are now in the midst of a long overdue and much needed national conversation about the next stage in our relationship with China. And while I will indeed be spending quality time thinking about the recent past and what it means for the future, I don't want to miss the chance to join in that conversation from time to time, allowing the exchange of ideas to sharpen my thinking, and helping me to zero in on the trends and

developments that matter most. That's what brought me to the Munk School, and that's why I am so happy to be with such a well informed and experienced audience as you this evening.

I have to admit that leaving Beijing wasn't like my departure from the other posts in which I have served. I have always left postings carrying with me a tidy narrative about the place, a storyline that attempts to sum up the country and its relevance for Canada.

But a single, satisfying China narrative eluded me. Far from feeling confident about having a single coherent account to explain what I had seen and experienced, I could fairly easily summon two competing, seemingly mutually exclusive ways of describing the China I had just been living in.

James Fallows points to a similar phenomenon in *China Airborne* his excellent new book about China's rapid emergence as a major force in global aviation. He writes: "What is true in one province is false in the next. What was the exception last week is the rule today. A policy that is applied strictly in Beijing may be ignored or completely unknown in Kunming or Changsha. Their country is a success and a failure, an opportunity and a threat, an inspiring model to the world and a nightmarish cautionary example."

Far from being tightly controlled and ideologically monolithic, China is diverse, contradictory and often chaotic. And these contradictions, very real themselves, are what give our own Canadian conversation about China such relevance and urgency.

I arrived in Beijing in the summer of 2009, a time when, for most countries, economic indicators were pointing down. But this was the time of China rising. As pessimism took hold in the West, there was a feeling that China could do no wrong. Cities that most people had never heard of now boasted gleaming skylines designed by famous architects. As national expenditures were being slashed worldwide, China was rapidly assembling a vast high-speed rail network and planning lavish international events. Expo 2010 was Shanghai's answer to Beijing's 2008 Olympic triumph.

This contributed to the sense that China's authoritarian government, far from being a drag on development, represented an advantage over multi-party democracy. People were convinced that the Chinese could get things done, investing them with a degree of infallibility and invincibility that hadn't been attributed to anybody, at least not since we

ascribed those same powers to the Japanese in the 1980s.

This growing admiration was not irrational. China's dynamism springs from some very real and very admirable sources. These include impressive skills at talent spotting and development. Particularly prized are the economic management skills that for 30 years have been the strong suit of Chinese officialdom. That's largely because getting to the top requires ascension through increasingly demanding management tasks whose scale (directing multi-billion dollar enterprises or leading provinces with populations several times larger than Canada's) build a formidable degree of competence.

There are other factors at play, like the degree of real competition found in the Chinese system. This means that whatever the target Beijing sets, local officials vie do outdo one another in over-shooting it. Generating more impressive numbers than the mayor or governor next to you, rather than meeting Beijing's latest target, is the most important consideration. And the system encourages experimentation. Ideas that prove themselves in a second tier city in Shandong get implemented in Beijing and Shanghai.

China in 2009 was seen as having avoided the excesses that hobbled western economies, particularly the US economy. Despite having endured decades of lectures from US policy makers, it was China that was capable of powering past the economic crisis on a wave of stimulus funding. This created an unprecedented demand for commodities that in turn pumped vitality into economies like Australia's and our own.

But the mood among China watchers is today more cautious, even downbeat. This is in large part due to the very fact that China has successfully linked itself to the global economy. Its most important market is the Eurozone, with the US not far behind. Its economic model has been based on the premise (to paraphrase Beijing University professor Michael Pettis) that China overproduces while the US and Europe over consume. That bargain is now broken. Absent robust recovery in both places, China has no choice but to grow domestic demand.

But doing that will require extensive and politically painful changes to the Chinese system. China's response to the global economic crisis has come in the form of a massive reinvestment in the State sector, something that entails a transfer from China's households to its State Owned Enterprises.

For the vast majority of China's citizens the reality is low wages, low interest rates and an undervalued currency. They save massively to provide a cushion against illness and age, and to help the next generation buy housing. The absence of attractive investment options *other* than real estate (and price to income ratios in China's cities are now daunting) means that domestic demand has fallen steadily as a component of GDP while government driven investment stands at close to 50%. If China's consumers are to take the place of European and American ones, we will have to see a major transformation in China's economic model.

This will in turn require a long overdue transformation in governance. At a time when almost every media commentator is repeating the stock phrase that China is approaching a "once in a decade change in its top leadership," the timing would appear to be propitious.

But even if the public and the wider world were privy to whatever policy discussions are going on behind the walls of Zhongnanhai and other power centers, we would probably discover that such a transformation is not in the cards, at least not for the near term.

The guiding principle at transition is always to ensure stability. But transforming a system in which the State and its top leaders both drive and benefit from economic growth will be extremely painful and contentious. For China, economic reform almost certainly entails even more profound political reform.

David Shambaugh is an American academic who writes impressively about China. In his book *China's Communist Party: Atrophy and Adaptation*, he traces the process of renewal the Party has taken since the bloody crackdown at Tiananmen and the collapse of the Soviet Union. The Party has spent years analyzing the failures of the Soviet state and comparing them with conditions in China. Their conclusions helped create a blueprint for more than 20 years of stability and growth. The blueprint favoured economic reform over political reform. It broadened Party membership to include entrepreneurs, and improved the Party's ability to consider emerging ideas and different points of view. This last improvement was accomplished through what is termed "intraparty democracy," creating more room for debate within a bigger Communist Party tent.

But even the biggest tent can't accommodate all the baggage

the Party has accumulated. Two large existential issues in particular cannot be crammed inside its walls. The first is respect for the rule of law. The Party currently seeks to stand above the law. Judges, for example, are expected to follow the Party's guidance. This limits development on many fronts, and renders inevitable China's manifest failure to rein in corruption. Deposed Premier Zhao Ziyang wrote, in memoirs collected during long years of house arrest, that absent significant political reform, corruption would emerge as an issue that would corrode faith in the Party and act as a drag on economic growth. We are seeing that happen.

Even more fundamental is the Party's failure to respect the dignity and basic rights of the individual. The Party's record on this subject is, of course, deplorable. In the best of times, individuals are little more than economic units. The worst of times have included Tiananmen, the Cultural Revolution and the Great Leap Forward. That this tragic legacy is not yet a topic of official discussion suggests that China, whose young people are at the same time creating one of the most connected and creatively subversive societies on the planet, is storing up troubles for the not too distant future.

So where does all of that leave us in thinking about the way forward for China? *The Economist* recently weighed the evidence and suggested that the most likely conclusion is that China will "muddle through." If we look at China's track record over the last 30 years, and its depth of talent and entrepreneurial energy it is hard not to agree. This is all the more true if we consider that China has a cushion of reserves sufficient to absorb more than a few shocks.

This is where my single narrative falls apart. Two possible futures can easily be envisioned. The rising, ambitious and dynamic China that we all saw in 2009 has not been submerged by the rising waters of debt, corruption and mismanagement.

At least not yet. My strong sense is that unless China returns to the slow but steady process of political reform – the path it had been on for much of the 1980s – within the next 3 to 5 years, the way forward will become much more difficult, threatening not just growth but also stability.

I think that we in Canada have a similar window within which to set an even more positive and more ambitious relationship with China, acknowledging that we will be

doing this with a changing and somewhat unpredictable partner. We have witnessed over the last few years a Chinese discovery of our country. This followed a pattern similar to China's discovery of Australia. Both processes are based on China's recognition, somewhat belated in our case, that Australia and Canada, almost alone on the planet, represent attractive opportunities for resource investment in a context of stability, predictability and rule of law (this last feature being considered a virtue in others).

We have also witnessed the magnetic attraction that Canada exerts over Chinese people, as a destination for study (young Chinese people make up 30% of our foreign student population) and for tourism: visa numbers are going through the roof. More telling still, Canada is a highly attractive destination for that considerable population of high-net-worth individuals in China who are, according to reliable surveys, looking for a second passport. These are people who understand that while you can make huge amounts of money in China, and quickly, you can lose it all just as quickly and with little to no recourse.

Canada has responded positively and effectively to this surge in interest. The Prime Minister and key members of the cabinet have worked hard to build a high-level relationship that is based on trust and predictability. This is paying off in terms of our ability to put in place the foundation pieces that an increasingly sophisticated relationship requires. Growth in tourist flows was triggered by Canada receiving something called Approved Destination status, which the Prime Minister secured in 2009. We have since added agreements on nuclear energy, on investment and on a range of agricultural access issues. Over the course of the last three years, the Prime Minister and the Chinese Premier have signed off on two lists of bilaterally agreed priorities, effectively setting the work program for ministers and officials.

While this represents real progress, we have a long way still to go. One of my problems, one of many, is that everything now looks a little bit like Afghanistan to me. I came to believe that Afghanistan was for us an example of what I would call a *real* foreign policy challenge. After several decades of having been able to arbitrarily select where and how we would get engaged in the world beyond our safe and secure North American base, we faced a situation in which we had to deploy national assets

– an expeditionary military, our international diplomacy, and a considerable portion of our aid budget – to achieve ends that were seen to be in the national interest – meaning the contribution required of Canada to ensure that Afghanistan never again became a platform for international terror.

China is, I think, a challenge of an even higher order. The national interest at stake is far larger and more immediate, and the challenge to our system is even greater. Our future prosperity, security and well-being depend on working out our relationship with a country that is almost wholly unlike us.

I am struck by how much of the rhetoric from those Canadians who are bearish on China involves reminding us of this unremarkable fact. China is different, often disconcertingly so. Now if whether to engage China or not was a matter of choice, we might well elect to spend our time on relationships that are easier to manage. But we don't have that choice. Not engaging China is simply not an option. For one thing, China, far and away our second most important economic partner, is already aggressively *engaging* us. We are graduating to the world of real foreign policy in which we need to confront a sometimes daunting reality, think carefully about our interests and our vulnerabilities (both are in play) and consider where and how to use diplomacy and various policy levers according to intelligent self-interest.

This will require us to work much harder in many areas. Let me point to two. A few weeks ago Jim Prentice delivered a speech here that included some choice quotes from the Chinese strategist Sun Tzu. My favourite was the following: “without knowing the lie of hills and woods, of cliffs and crags, you cannot march.” We have got to get more serious and systematic in thinking about China. The Australians, whom I have already invoked, are ahead of us in supporting work at universities and think tanks relating to the economic consequences for Australia of China's rise. I should add that the Australians – who are keenly aware of the similarities of our situations – would welcome more regular exchanges with us on this topic. We also need to do more to promote the study of Chinese by young people in Canada, a process in which Alberta represents the national best practice.

If the ancient Chinese reminded us the importance of knowing the other, the ancient Greeks reminded us of the importance of knowing ourselves. We need to think carefully

about what *we* want from a relationship with China. And by this I don't mean assembling the lengthy laundry list that can sometimes pass for a strategy in Ottawa. Instead we need to focus on the three or four things that we absolutely have to get right as a country. And let me suggest that doing even more thinking about the economic relationship, and particularly its investment dimension is job 1. We then need the honesty, discipline and competence to act in ways that maximize the advantages and minimize the very real challenges that a relationship with China entails. This will require of us a higher degree of connectedness than we typically exhibit.

Again, this isn't so much a matter of crafting a complicated and unwieldy strategy as it is a matter of working in concert, federally and provincially, private sector and public sector, to encourage and, and, where necessary, guide the Chinese to ensure that their current and *emerging* investors respect Canadian laws and regulations, have faith in the workings of our market, and understand what we can term the Canadian advantage.

We shouldn't assume that the Chinese automatically understand that, for example, having a head office in Calgary, hiring talented Canadians and taking full advantage of our exceptional educational system, aside from being what we would naturally seek, also happen to make good business sense. This is, by the way, pretty close to the message that the China Investment Corporation now shares with global media.

Communicating this effectively and consistently to others will require establishing even more bilateral dialogue mechanisms with the Chinese. Think, for example, about an annual energy dialogue, involving the private sector and government, in which we talk about research, technology, infrastructure, education and the environment – in which we build relationships, expand understanding and encourage what I call the habit of collaboration. This is something, by the way that the Americans do very well.

Let me close with a few words on reciprocity. At their fewest they would be: great in theory, hard in practice. That's in large part because the Chinese, by virtue of inclination and governmental architecture are good at it, and we, thank God, aren't. Related to this are the frequent asymmetries involved.

It is hard to justify punishing Beijing for blocking a Canadian project in China by ourselves blocking a Chinese project here. And when you have competing Canadian interests engaged on the two projects, the possibility of (not to mention the rationale for) mounting a surgical Canadian counter-strike diminishes further. There are limits to our connectedness.

But I do worry about this issue. The playing field is not level. By way of example, Canadian mining companies, for example, can extract resources that Chinese firms can't reach and in ways that are environmentally friendly and much better socially and economically for the surrounding community. But Canadian firms – like their US, Australian and South African counterparts – have been forced out of China by dodgy practices at the local level. Typically a well-connected local partner emerges at the last minute and muscles the foreign firm out of the production phase.

We need to communicate to the Chinese that our own open investment environment depends on the support of Canadians. That support will inevitably weaken if Canadians come to believe that the advantages are one sided. Our recently signed investment promotion agreement should help. Up until now, the central government in Beijing has been able to shrug helplessly and point us to the offending province. Through the FIPA, we should be able to take these cases to arbitration, meaning that Beijing will feel our pain, too.

And we know that China is susceptible to sustained pressure. They closed much of their market to Canadian canola, a 1.3 billion dollar export, in 2009. Sustained effort by the Prime Minister, by Minister Ritz, by the Canola Council of Canada and by the embassy helped to turn things around and reopen the market. It took an incredible amount of work, but it paid off.

Before thinking about reciprocity, we should be sure that we have put the energy and initiative into market opening, something that, like it or not, requires far more effort in China than it does in more established – and much smaller – markets.

That's not a bad note on which to close. China, our looming foreign policy challenge, will require of us an amazing amount of work. But it will pay off.