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THE MIDDLE POWER AND THE MIDDLE KINGDOM: SECURING CANADA'S PLACE IN THE NEW CHINA-U.S. ECONOMIC AND STRATEGIC WORLD ORDER*

Wendy Dobson†

Although the United States is finally showing signs of some slow economic recovery, in global terms North America is in relative decline as large emerging-market economies, particularly China, show much more promise for growth. But Canada, having relied on a north-south pattern of diplomacy and trade with the United States, is not well positioned to become part of this new economic world order.

China is paying attention. It has not escaped notice among the Chinese that Canada has been largely absent from the Asian region and its institutions in recent years, relying only on the inertia of a few longstanding bilateral relationships. An occasional visit to China by Canada's prime minister is not an encouraging sign — for Canada or China — of the Canadian government's commitment to building a more robust relationship, particularly when other countries have ongoing dialogue with China at the highest levels. And Canada's hesitance to join the Trans-Pacific Partnership, and a generally half-hearted attitude toward striking Asian free-trade deals, cannot have left China believing that Canada is serious about pivoting toward the Pacific. Indeed, new restrictions that further obstruct the ability of state-owned enterprises, from China and elsewhere, to invest in Canada likely signals that we are even outright hostile to the idea of forging deeper Asian ties.

If Canada is to ensure that it is strategically well positioned for an era of rising Asian power, it must learn to think more like a Pacific nation, and not strictly an Atlantic one. The expanding Asian middle class will soon demand improvements in health, education, financial, environmental and urban services: These are things that Asians know Canada can do well, and they would welcome Canada's expertise in developing these services. But Canada must show itself eager to integrate further with Asia, deepening relationships in the region's nascent economic and security institutions. Canada can also begin acting on longstanding recommendations that it promote itself as a Pacific "location" for Asian multinationals: Calgary marketed as a global centre for unconventional energy research; Vancouver as an ideal headquarters for Asian multinationals operating in the West; and Toronto as a Pacific-oriented international centre of yuan-based finance.

Rightly or wrongly, Canada is developing an international reputation as a difficult place to invest, and a country that is fairly indifferent to the potential that is already beginning to unfold in China and elsewhere in Asia. With so much of our economic future at stake, it is a reputation we must immediately begin working to reverse.

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† *This article draws on two longer publications by the author: Dobson, Wendy (2013). Partners and Rivals: The Uneasy Future of China's Relationship with the United States (Toronto: Rotman/University of Toronto Press) and "Canada, China and Rising Asia: A Strategic Proposal", (Ottawa: Canada China Business Council and Canadian Council of Chief Executives), available at www.ceocouncil.org.*

LA PUISSANCE MOYENNE ET L'EMPIRE DU MILIEU : ASSURER LA PLACE DU CANADA DANS LE NOUVEL ORDRE MONDIAL STRATÉGIQUE – CHINE / ÉTATS-UNIS*

Wendy Dobson†

Bien que les États-Unis montrent enfin des signes d'une lente reprise économique, l'Amérique du Nord connaît un déclin relatif sur la scène internationale tandis que les indices de croissance des marchés économiques émergents, en particulier la Chine, sont beaucoup plus prometteurs. Mais ayant tablé sur un modèle de diplomatie et de commerce nord-sud avec les États-Unis, le Canada n'est pas en très bonne posture pour se tailler une place dans ce nouvel ordre économique mondial.

Les Chinois sont attentifs à la situation. Il ne leur a pas échappé que le Canada est demeuré largement absent de la région asiatique et de ses institutions au cours des dernières années et que le pays n'a tablé que sur quelques relations bilatérales de longue date par voie de laisser-aller. Une visite occasionnelle en Chine du premier ministre canadien ne constitue pas un signe encourageant, que ce soit pour le Canada ou pour la Chine, de l'engagement du gouvernement canadien envers des relations plus solides avec ce pays, d'autant plus que d'autres gouvernements entretiennent un dialogue avec la Chine au plus haut niveau. De plus, l'hésitation du Canada quant à son adhésion au Partenariat transpacifique, ainsi qu'une attitude plutôt tiède à l'égard des accords de libre-échange avec l'Asie, n'a certes pas été de nature à convaincre la Chine que le Canada envisageait sérieusement un virage vers le Pacifique. Il ne fait aucun doute que les nouvelles restrictions qui nuisent encore davantage à la capacité des entreprises gouvernementales, en Chine ou ailleurs, d'investir au Canada constituent vraisemblablement une indication que nous sommes même carrément hostiles à l'idée de forger des liens plus approfondis avec l'Asie.

Si le Canada veut s'assurer d'être en bonne position stratégique dans un monde de plus en plus dominé par l'Asie, il doit se percevoir davantage comme un pays tourné vers le Pacifique, et non pas seulement vers l'Atlantique. La classe moyenne asiatique en pleine croissance demandera bientôt des améliorations dans les services de santé et dans les services éducatifs, financiers, environnementaux et urbains. Les Asiatiques savent que ce sont des domaines où le Canada excelle, et l'expertise canadienne serait bienvenue dans le développement de ces services. Toutefois, le Canada doit manifester sa volonté ferme d'accentuer son intégration avec les partenaires asiatiques en approfondissant ses relations auprès des institutions axées sur l'économie et la sécurité de cette région émergente. Le Canada peut également commencer à donner suite aux recommandations de longue date selon lesquelles le pays doit se promouvoir en tant que « destination » pour les multinationales asiatiques : Calgary comme centre international pour la recherche non conventionnelle dans le domaine de l'énergie; Vancouver comme pivot idéal pour les multinationales asiatiques qui mènent des opérations en Occident, et Toronto, à titre de centre financier international axé sur le Pacifique et le yuan.

À tort ou à raison, le Canada est de plus en plus perçu sur la scène internationale comme un lieu où il est difficile d'investir et comme un pays passablement indifférent au potentiel qui se déploie déjà en Chine et ailleurs en Asie. Étant donné qu'une part si importante de notre économie est en jeu, nous devons dès maintenant tâcher de renverser la vapeur.

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† *Cet article se fonde sur deux articles plus approfondis du même auteur : Dobson, Wendy (2013). « Partners and Rivals : The Uneasy Future of China's Relationship with the United States » (Toronto: Rotman/University of Toronto Press) et « Canada, China and Rising Asia: A Strategic Proposal » (Ottawa : Conseil d'affaires Canada-Chine et Conseil canadien des chefs d'entreprise), disponibles à l'adresse : www.ceocouncil.org..*

INTRODUCTION

Power relationships in Asia are shifting rapidly, yet Canadians lack a strategic framework within which to anticipate and respond to these changes to promote their own long-term interests. Central to any strategic view of Asia in the future world economy is the relationship between China and the United States. They are the world's two largest economies, with China expected to overtake the United States in size sometime in the next two decades. How will those two — and indeed other countries, including Canada and a number of Asian nations that rely on the United States for economic and strategic security — respond? Signs in early 2014 are not encouraging amid increasing tensions and uncertainty in the region.

Some predict a great power rivalry between China and the United States, where only one can win.[1] The reality could be quite different. Their economic fates are deeply intertwined and each has major domestic challenges that require much political capital to address. My thesis is that their economic imperatives can trump politics; rivalry is inevitable, but the two powers can also be partners. Rivals in pursuing their respective national interests; partners in addressing global challenges and producing "public goods" of the future demanded by their respective publics, such as slowing climate change, preventing nuclear proliferation and governing cyberspace and the militarization of outer space.

At their informal summit meeting in California in 2013, both U.S. President Barack Obama and China's President Xi Jinping spoke about a "new great power relationship" being possible with wise leadership, careful management and investments in deepening the knowledge necessary to deeper mutual understanding of each other's goals and strategies.[2] Their relationship in the postwar period has been a complex one, with close co-operation in the face of a common Soviet threat, following president Richard Nixon's informal meetings with Mao Zedong in 1972. Since China's reform and opening in 1978, the relationship has waxed and waned, becoming increasingly uneasy in recent years. In June 2013, with both leaders beginning fresh political mandates, they signalled their intentions to pursue a more co-operative path and invest in deeper mutual understanding. Such a course, pursued beyond President Obama's second term and throughout Xi Jinping's 10-year mandate, could change the arc of history.[3]

Why does it matter? The world's two largest economies are established and rising powers with deeply different living standards, histories, goals, values and institutions. In its two-century history, America has grown from a colony into the world's sole superpower. In the same two centuries, China saw the decline and eventual collapse of its ancient dynastic system of emperor rule, as well a humiliating invasions and oppression by foreign powers. Following the founding of the People's Republic in 1949, Mao Zedong turned the country away from the western world until President Nixon's visit.

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[1] See Chapter 7 in Dobson (2013).

[2] "Full Text of China-US Joint Statement", January 19, 2011, Washington. Available at http://news.xinhuanet.com/english2010/china/2011-01/20/c_13698492.htm, accessed December 2012.

[3] Wendy Dobson, *Partners and Rivals: The Uneasy Future of China's Relationship with the United States* (Toronto: Rotman/University of Toronto Press, 2013); and David M. Lampton, *Same Bed, Different Dreams* (London: University of California Press, 2001), 301-309.

Each of the two powers considers itself to be exceptional. Americans see their democratic system as superior to all the others; they see their national interests as best served by an active role in the world, spreading the virtues of democracy, market capitalism and globalization, and by having the world's most powerful military to maintain order and prevent disorder.

Chinese have their own exceptional history as home of the world's oldest empire and of the Middle Kingdom, which existed for more than two millennia. To them, China's successful re-emergence merits the world's respect. With persistence and patience, the country is regaining its status as a great power. But there exists a paradox: At the same time, the evolving Chinese mindset is traditionally inward-looking and agrarian, with memories of vulnerability and humiliation that should never happen again, fuelling sensitivities towards outsiders if they are seen to offend the intense national pride in China's accomplishments.[4]

Chinese foreign policy is driven, first and foremost, by domestic interests and the Communist party's need to legitimize its autocratic rule. China's enterprises are expanding their global footprints and the government is intent on developing the military capabilities associated with a great power. The G20 leaders' forum created in 2008 to include China, has seen China participate but not lead. There are good reasons for this, one being China's reluctance to take on any international obligations that might undermine its central domestic goals of stability, growth and jobs. Chinese also still see themselves as poor; China may soon be the world's largest economy, but Chinese believe they have many domestic problems that must be addressed before helping others. It is worth noting that the United States during the Great Depression was reluctant to act as the stabilizer in the international economy, largely because it had not yet thought through such a role.

China's sense of vulnerability remains close to the surface. Members of the security and intelligence communities frequently express the conviction that the United States, in Cold War fashion, aims to contain China's rise, never mind that the degree of interdependence — with huge volumes of trade, investment, capital and people between the two giants — directly contradicts this notion. Such sensibilities are reflected in China's leaders' goals for stability and security, to protect sovereignty and territorial integrity and to build a strong economy and nation.[5]

All of these factors matter in assessing the future China-U.S. relationship. I focus on two main questions: What does China want? And what is an agenda for deepening the mutual knowledge and trust necessary for a co-operative long-term relationship?

WHAT DOES CHINA WANT?

China's unbalanced domestic economy is a significant internal source of vulnerability. Leaders face huge domestic challenges following more than three decades of rapid growth. The economic model has become unsustainable and must be changed or China risks falling into the middle-income trap in which growth stagnates and is difficult to revive. Adding to this risk is the resistance to change coming from powerful interests, the beneficiaries of the old fast-growth industrial model.

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[4] Dobson, *Partners and Rivals*, Chapter 5; and John King Fairbank, *China: A New History* (Cambridge, Mass: Belknap Press of Harvard University Press, 1992), 137-39.

[5] Dobson, *Partners and Rivals*, Chapter 7.

A stable international environment is necessary for focusing at home. The U.S. relationship is particularly important, not least as an economic partner, but significantly in Asia where China's vulnerability to America's recent energetic rebalancing has evoked fears of Cold War containment and driven President Xi's push for a "new type of great power relationship."[6] While it has become a commonplace to summarize China-U.S. interdependence as China being America's "banker," the reality is more complicated. China's rise results from its own efforts, but the 2008 global financial crisis accelerated a relative shift as growth evaporated in the United States and Europe. This shift is reversing somewhat as those economies recover. As one of the world's leading trading nations, China depends on foreign demand to help maintain growth as it navigates through its major structural changes. A major source of that growth in the next few years is likely to come from the United States.

China's domestic challenges are complicated and there is no silver bullet for solving them.

First, China's population is aging while people are still relatively poor. Increasing numbers of elderly dependents must be supported at the same time that additions to the workforce are diminishing year by year.

Second, Chinese leaders have recognized the economic growth model as "unsustainable, unco-ordinated, unbalanced and unstable," a characterization made by former premier Wen Jiabao on the margins of the 2007 National People's Congress.[7] More balanced and sustainable growth will require major adjustments on the supply side to increase productivity, and on the demand side to reduce serious distortions that favour producers over households and investment over consumption. Income inequality is growing (China's Gini ratio has increased from 0.30, denoting relative equality, to 0.47, higher than the inequality index of the United States); environmental degradation is feeding popular dissatisfaction; and the regional impacts of mobilization are also unequal, with most of the benefits of growth accruing to the coastal regions. Households bore much of the burden of the growth sprint.[8] The consumption share of GDP has declined in recent years to around 34 per cent of GDP, which compares unfavourably to India's 54 per cent share.[9] At the same time, China's investment rate has reached 50 per cent of GDP, financed by households' high savings. With savings rates even higher than investment, China could run a trade surplus.[10]

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[6] See: David Lampton, "A New Type of Major-Power Relationship: Seeding a Durable Foundation for US-China Ties," *Asia Policy* 16 (July 2013): 12.

[7] Dobson, *Partners and Rivals*, Introduction and Chapter 3.

[8] Bloomberg News, "China Approves Income Plan as Wealth Divide Poses Risks," February 5, 2013, http://www.bloomberg.com/news/2013-02-05/china-approves-income-plan-as-wealth-divide-poses-risks.html; Lardy and Borst report an unofficial household survey that found the Gini ratio in 2010 to be 0.61. See: Nicholas Lardy and Nicholas Borst, "A Blueprint for Rebalancing the Chinese Economy," Policy Brief PB13-02 (Washington, DC: Peterson Institute for International Economics, 2013): 7.

[9] Michael Pettis, *The Great Rebalancing: Trade, Conflict, and the Perilous Road Ahead for the World Economy*, (Princeton: Princeton University Press, 2013), 77. Nicholas Lardy reports that by comparison, India's consumption share in 2007 was 54 per cent of GDP. See Nicholas R. Lardy, Sustaining China's Economic Growth: After the Global Financial Crisis (Washington, D.C.: Peterson Institute for International Economics, 2012).

[10] See: World Bank, Commission on Growth and Development, *The Growth Report: Strategies for Sustained Growth and Inclusive Development* (Washington, D.C.: World Bank, 2008), 21, http://www.growthcommission.org/indes.php?option+com_content&task+view&id+96&Item; and International Monetary Fund, "Brazil: Staff Report for the 2012 Article IV Consultation," June 22, 2012, available at www.imf.org.

Changes on the supply side of the economy will not only help to sustain growth, but will reduce distortions on the demand side. Such changes are needed in four areas:

- Change the role of the state by reducing its role in subsidizing input prices for energy and use of the environment, which contribute to environmental degradation; revise the roles of state-owned enterprises (SOEs), which dominate strategic sectors, face limited competition and pay little in dividends. Introduce more competition and raise SOE dividends to finance the social programs and safety nets required by an aging population and by the labour force, which must adjust to economic change.
- Modernize the financial system by allowing market-determined interest rates, replacing administered low lending rates favouring producers, and develop the regulatory and legal infrastructure required for deep, sound and liquid capital markets. More than any other change, higher returns to household savings could bolster household incomes and domestic consumption.
- Revise the rules for land use to give farmers a better deal when their land is converted to urban uses, and provide alternative sources of revenue for local governments to augment or replace land sales to pay for the services they are expected to deliver.
- Reform the *hukou* household registration system to phase out discrimination against migrant labour from rural areas. A new urbanization strategy that has already been announced will require more than financial investment to succeed; *hukou* reform is necessary to give migrants access to public services, while the deregulation of service industries is needed in order to provide more jobs.

These reforms move beyond the old model, based on mobilizing labour, capital and land, to one that changes incentive structures, which comprise the "software of growth."[11] Different incentives are necessary, ones that encourage economic agents to find new, more innovative ways of using available inputs and re-organizing production, thereby raising productivity. The software includes incentive structures that influence workers to be productive by rewarding education and skills training and facilitating labour mobility; incentive structures that encourage producers to be competitive and innovative; financial institutions that allocate capital efficiently and reward savers; legal institutions that protect property rights; and economic institutions that encourage openness to trade and finance.

In recent years, however, the momentum for the difficult supply-side reforms has actually slowed. Some movement occurred on the demand side as public spending on social programs increased to tackle income inequality. But the party continued to mobilize inputs to maintain the fast growth in output and jobs needed to maintain its legitimacy. Little action was taken to reform policies and institutions that favoured producers over households and goods production over services. Income was extracted from households and transferred to enterprises at cheap input prices. Environmental regulations were not enforced. Sectors reserved for state-owned enterprises (SOEs) actually expanded, restraining competition. The under-valued exchange rate contributed to external imbalances and international tensions.

[11] Such an analysis was provided by Wendy Dobson, *Gravity Shift: How Asia's New Economic Powerhouses Will Shape the Twenty-First Century*, (Toronto: University of Toronto Press, 2009).

Third, China faces a catch-22 situation. Without these reforms, China risks falling into the middle-income trap in which growth stalls as mobilization strategies produce smaller and smaller increments in output and China loses competitiveness with other emerging-market economies but fails to move up the value chain to compete successfully with more developed economies. It also risks increasing social unrest. The old growth-at-any-cost policies created entrenched interest groups resistant to those changes that fail to serve their interests. At the same time, a growing and more vocal urban middle class is now expecting such change. The longer the delays in changing course, the larger the economic distortions and the greater the political difficulties of correcting them. Indeed, a key question is whether outdated policies and institutions can be changed without creating a crisis. Ezra Vogel's recent penetrating biography of Deng Xiaoping tells us how reform and opening slowed down after Deng Xiaoping retired, bringing him back once more into the fray with the famous southern tour in 1992.[12]

A "southern tour" today would emphasize productivity growth as the major new source of growth. It requires innovation, individual initiative and risk taking. Typically, this in turn calls for less state control and a smaller role for government to encourage market forces and competition. Returns to innovation are realized at some future date, so greater transparency is needed in sound accounting rules, the recognition and enforcement of property rights, and rules protecting intellectual property to which producers are subject, no matter who they are or who they know.

The reality, however, is that it does matter who you know and who you are. Party members are widely seen as using their control and privilege to help themselves to the opportunities and the spoils of economic growth, while convincing themselves that associated growth in jobs and household incomes confers the legitimacy needed to retain power. Major economic disparities are now on public display as the number of Internet users reaches half-a-billion people and an estimated 300 million people access social media. Many Chinese readily admit that their material circumstances and economic freedom have improved in their lifetimes more than they could have imagined possible. They do not object to some people becoming rich from their own efforts and ingenuity, and many Chinese have done just that. It is *how* they get rich that makes the difference. Too many engage in rent-seeking behaviour in which privilege, connections and corrupt practices are used to game the system by reinterpreting or getting around the rules that apply to everyone else. Some argue that there are parallel states: a party state for those with the right connections, and a legal state, which applies to everyone else and permits the sometimes-brutal repression of protestors and critics by the public-security apparatus.[13]

Fourth, the population tolerated the party's authoritarian ways because of the jobs created, the rise in living standards and increased economic freedom. Party members insist that loosening its political grip risks triggering a "Gorbachev moment," in which the country descends into chaos similar to that which followed Russia's political and economic liberalization in the late 1980s. On the other hand, increasing pushback from netizens, citizens, journalists, academics and others suggests that continuing the party's autocratic ways could itself become the source of future social unrest.[14]

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[12] Ezra F. Vogel, *Deng Xiaoping and the Transformation of China* (Cambridge, Massachusetts: Belknap Press for Harvard University Press, 2011), 664-690.

[13] Dobson, *Partners and Rivals*, Chapter 3.

[14] Dobson, *Partners and Rivals*, Introduction.

Tackling privilege and connections is complex because of the difficult institutional questions about the role of the state, checks and balances on power, greater transparency and the rule of law. Xi Jinping has accorded the clean up of corruption a remarkably high priority, assigning an accomplished (and uncorrupted) leader to the task of exposing and punishing both the corrupt powerful "tigers" and lower-level "flies." Economists, however, look at the incentive structures that encourage the parallel realities and that need to be dismantled. Disciplinary action is only the first step, especially since party members are above the law and subject to disciplinary oversight and action only by party organs. This is a far cry from the "newspaper test" applied to the behaviour of officials and individuals in countries with a free press and a judiciary with the independence necessary to check abuses of power.

Relationships have deep historical roots in informal *guanxi* networks of mutual trust in which personal or clan relationships or geographic proximity substitute for the rule of law. Increasingly however, they contribute to the ambiguous impacts of the partly developed legal system. In the absence of well-defined property rights, everyone is vulnerable to score settling. The distortions in the system are illustrated by two different reports. First, increasing numbers of wealthy Chinese are moving their assets offshore in response to the risks of uncertain property rights and social disorder. Second, estimates of social protests (the traditional channel for righting wrongs, rather than legal or political action) now range upwards of 200,000 a year. Increasingly, the authorities are resorting to compensating the noisiest players; the budget for financial compensation (*weiwen*), included in spending on law and order, now exceeds that for military spending.[15]

In sum, under increasing domestic pressures, China's leaders are seeking new directions. These are distinctively Chinese and will play out significantly within the next decade. Xi Jinping's slogan of the "Chinese dream" could herald a new chapter in reform and opening. Within his first six months in office, the effect was uplifting but the concept sufficiently vague that it became a vessel into which people poured their hopes and cynicism. Some see it as an invitation to nationalists, others as a vision of a strong, civilized, harmonious and egalitarian nation, while still others deride it as too vague for citizens whose dream is to be able to buy safe baby formula for their children and to breathe clean air.

Addressing these domestic challenges will be difficult. Progress is being measured both in months, but also over decades. Expectations have been raised. Managing them could absorb much of the leadership's political capital, leaving little time and attention to guide China's role in the world and its relationship with the United States.

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[15] Xi Chen, "China: Two Faces of Protest," *Asia Pacific Memo*, October 24, 2012, www.asiapacificmemo.ca/china-two-faces-of-social-protest.

CHINA AND THE UNITED STATES CAN HAVE A CO-OPERATIVE AGENDA

The success of its growth sprint despite these flaws has surprised China's leaders and people, and the rest of the world, where its growing impacts are both benign and uncertain. Increasing flows of tourism, flows of trade and investment, and the growing use of the yuan as a regional currency are all relatively benign trends. In contrast, major questions arise about China's impact along with the United States, as the world's two largest carbon emitters. The two giants have also bumped into each other in Asia where China's uncoordinated economic and military activities in its offshore waters, and bullying political behaviour, have backfired, alarming its neighbours and unravelling years of friendly diplomacy as those neighbours turned to the United States to step up the pace of its re-engagement in the region. America's much-publicized "pivot" in turn raised Chinese sensitivities and frustrations.[16] Frequent predictions of rising antagonism do not have to be the reality if leaders at the top on each side are willing to invest in the geopolitical framework — the runway needed to support a positive-sum trajectory for the relationship.

How do Chinese and Americans see each other?[17] A wide range of views can be found on both sides. Chinese views can be differentiated into zero-sum nationalists, ever mindful of China's historical vulnerabilities and humiliation, and more positive-sum internationalists. The first and influential group are convinced that America aims to contain China's rise; they see the Chinese economy as strong enough to stand up to the United States. At the other end of the spectrum are internationalists who argue for China to get its economic house in order, address its internal tensions and co-operate more closely with America. An open question is whether China's leaders will transcend the pressures from those with the zero-sum view and conduct the relationship as a mature global power. American views extend across a similar spectrum, with an official view that is relatively positive toward supporting Chinese prosperity. Recent concerns about cyber security have drawn a red line, however, underlining the need to frame mutually acceptable goals and make greater use of multilateral forums where other countries can buffer bilateral frictions.

A two-part co-operative policy framework and agenda could move the relationship onto a new trajectory. One part is the inside game between governments; the second part is the outside game involving their publics, third countries and global collective issues.

The inside game between governments should recognize two principles: that neither nation can dominate the other and that reducing mutual mistrust requires focused and regular attention from top-level leaders. Leaders will set the tone, goals and agenda and high-level officials should be tasked with managing follow-through on co-operation and setting limits on the rivalry that is inevitable in pursuing national interests. It includes deeper engagement through diplomacy and inter-governmental negotiating machineries. Security experts emphasize the importance of regular military exchange at all levels to reduce uncertainty about each other's goals and strategies, particularly in the Pacific region. Some bold measures would deepen the engagement of the business communities and facilitate trade and investment flows. They work towards both a bilateral investment treaty and a free-trade agreement.

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[16] See: Acharya Amitav, "China's Rise and Asia's Security: Towards a Consociational Regional Order," manuscript (2012); Stephan Fruhling, "US strategy: between the 'pivot' and 'Air-Sea Battle,'" *East Asian Forum* (August 26, 2012) http://www.eastasiaforum.org.

[17] Dobson, *Partners and Rivals*, Chapter 5.

The outside game is dominated by the dynamic Asian region. Both giants have to make room for the other in their relationships and interests in the region. Both should support Asia's nascent institutions for security and economic co-operation and both should be included in regional trade negotiations. Public engagement can be stepped up in recognition of the need for public support as a foundation stone of co-operation. Significantly, bilateral co-operation is a necessary prerequisite for producing important new global public goods, such as slowing climate change, and creating new regimes to govern the use of outer space and the increasingly fraught arena of cyberspace. No global regimes are possible without the two countries and neither can tackle these issues on its own. The continued absence of global rules of conduct in space and cyber space could lead to future conflict.

In conclusion, the informal bilateral summit in California eased the increasingly tense relationship and nudged the trajectory towards greater co-operation. Looking ahead, major milestones against which to monitor further progress will include following through with more informal leaders' meetings and the growth of political support for economic reform, received for some but not all elements of the market-oriented agenda at the Third Plenum of the Party Congress in November 2013 and forthcoming from the rubber stamp People's Congress in March 2014. In the United States, progress has been made on the vexed politics of U.S. medium-term fiscal consolidation, but President Obama's absence from the annual East Asian Summit, Secretary of State John Kerry's relentless focus on the Middle East at the expense of the U.S. geopolitical profile in the Asia-Pacific region, and uncertainty about the fate of the Trans-Pacific Partnership (TPP) negotiations in Congress, have raised the stakes in 2014. The stakes are even higher as Japanese President Shinzo Abe raises Japan's regional security profile. And an alternative dark scenario involving North Korea is always possible, where miscalculations or distractions, and the failure to manage the potential flashpoints in North Korea, Taiwan or the East China Sea, split the region into contesting camps. The China-U.S. relationship will be central to managing the world economy in the decades ahead. Deeper co-operation will be hard work, but that is far superior to the consequences of continuing the recent drift towards mistrust and antagonism.

CANADA NEEDS A WHITE PAPER ON ASIA

What does all this imply for Canada? First and foremost, it implies the need for a strategic framework to replace the ad hoc, warm and cool politics of the past few years. We need a white paper on Asia that educates Canadians on the region's future and Canada's long-term response. This is not an elitist project. It is about the options we leave to future generations. Right now there is a sparse Asian narrative in Canada and remarkable complacency about our role and future in the region and the world. Too often there is a tendency to assume that somehow our North American location and natural resource abundance will assure our future living standards.

As noted earlier, however, even though the United States is now experiencing a slow recovery from the great recession, in global terms, North America is in relative decline as China and other large emerging-market economies grow much faster toward the future.

Canada's Asia Strategy should have a clear statement of mission and a set of milestones for the next few years. It should also be generational; not something to be ignored or downgraded by a new administration arguing "the other guys did that." Much of the strategic framework will be about Canada: the "brand" that can be built based on our economic strengths and our Pacific location. But first we should examine our views of ourselves and how others see us. Most Asians have seen a country that has been a constructive player in world affairs. Even though Canadian soldiers fought in the Korean War, and Dr. Norman Bethune is still well known to Chinese who read in school Mao Zedong's famous essay in his honour, Canada is seen as oriented towards the United States and the Atlantic rather than the Pacific. In recent years, Canada has been viewed as largely absent from the Asian region and its institutions, relying instead on a few longstanding bilateral relationships.

The Asia strategy proposed here is not about hedging against U.S. relative decline and its current inward-looking and sometimes careless politics. It is about building on the challenges faced by Asian countries and on our strengths. It is about developing a long-term strategy for the "Asian Century," in which Asians themselves are trying to decide what to make of their role in the world and its institutions.

As Asia's middle classes grow in the next two decades (the Asian Development Bank estimates two-billion middle-class Chinese and Indians by 2030), and as governments encourage massive urbanization, what will follow will be enormous demands for more sophisticated health, education, financial, environmental, and urban services.[18] With an estimated 13 of the world's largest 25 metropolises, these middle classes will also seek liveable cities. It is well known in Asia that Canadians do all of this well.

Canadian strengths in education are already recognized and in demand from Chinese, Indian and Korean parents. Statistics Canada reports that, in 2012, Chinese students alone accounted for 30 per cent of the total number of international students followed by Indians (11 per cent) and Koreans (seven per cent). Americans accounted for 4.6 percent. Interest in Canadian natural resources, both in terms of demand for supplies and enterprises wishing to invest in resource-development companies and projects is strong, though somewhat diminished by restrictions imposed in late 2012 on investments by state-owned enterprises (SOEs), a subject to which I return below.

Canada lacks a framework for deeper integration in Asia. While China is now our largest trading partner in the region, mainly due to market forces, we have been remarkably slow to flesh out official frameworks through trade and investment agreements within a strategy for the region. Elements of this strategy should include a geopolitical thrust, leadership *within Canada* to enhance the Canadian profile in the region by creating a mechanism at home that co-ordinates the efforts of the many interested players who currently turn up on their own, and targets for trade and investment liberalization.

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[18] Asia Development Bank, *Asia 2050: Realizing the Asian Century* (Manila: Asian Development Bank, 2011), 24.

Engaging in Geopolitics

Two steps are required to raise Canada's geopolitical profile: relationship-building with other leaders and participation in the region's nascent economic and security institutions.

In Asia, more so than in the West, key building blocks among countries are state-to-state linkages and relationships at the highest levels; relationships that are carefully built and maintained. The prime minister visiting China once every few years and leaving the maintenance of ties to ministers and the Governor General in between, is not adequate to deepen the foundation upon which all other cultural, economic and security ties must be based. In contrast, the United States and China maintain the high-level Security and Economic Dialogue. Tiny Singapore and China have assigned a senior Singapore official and a member of the seven-person Politiburo Standing Committee (China's top decision-making body), respectively, to manage the relationship.

More broadly in the region, Canada is a member of the Asia-Pacific Economic Cooperation (APEC) forum, a largely consultative forum with members from both sides of the Pacific. But Canada is not a member of what will become the region's apex institution, the East Asian Summit (EAS), which includes leaders from all the large countries stretching from the United States to India and Russia, but which now seems reluctant to admit more members. Canada is, however, gradually becoming more active in the various security forums which the Association of Southeast Asian Nations (ASEAN) sponsors for defence and security consultations.

Developing the Canada Brand

Canada should also come to terms with the fact that it is a Pacific nation but does not yet think like one. Suggestions that we become a Pacific "location" for Asian multinationals have fallen largely upon deaf ears. Yet Calgary should be marketing itself as the location of unconventional energy research, Vancouver as an ideal headquarters for Asian multinationals operating in the Western Hemisphere, and Toronto as an Pacific-oriented international financial centre, including being a North American hub for yuan-based finance as China's currency grows in international transactions.

Beyond that, Canadians require a workable mechanism for co-ordinating a consistent long-term Asian strategy. Does the plethora of players, including provincial premiers, educational institutions and private and public enterprises presenting themselves separately in Asian capitals work to Canada's long-term benefit? The federal government should be convening a mechanism that brings these players together around a set of agreed-upon goals and strategies. Team Canada trade missions worked for a while; today we need a forum in which the provinces co-ordinate with, rather than hold up the federal government.

The goals of this strategy should include five- and 10-year targets for two-way flows of trade, direct investment, and tourism, as well as flows of Asians to Canada for educational purposes. Further, targets should be considered for two-way people-to-people engagements, such as through friendship societies and twinning arrangements. Canadian students should be encouraged to learn an Asian language as a prerequisite for high-school graduation, similar to a goal articulated in Australia's 2012 white paper, *Australia in the Asian Century*.

Liberalizing Trade and Investment

TRADE: A well-known factor undermining the seriousness of Canadian interest in Asia is that we failed to complete any free-trade agreements with Asian countries at a time when such agreements were proliferating within the region and beyond as barometers of friendly foreign relations. Negotiations with Singapore began in 2001, but even today the talks languish without a conclusion. The log jam was finally broken with the recent completion of negotiations with South Korea that began in 2004. In both cases, special-interest groups in Canada have held hostage the national interest with unrealistic insistence upon treatment equal to that accorded the United States with its huge and wealthy market. In the early stages of the Trans-Pacific Partnership (TPP), Canada refused an invitation to join, thereby denying itself the opportunity to shape the negotiating agenda. The landscape has changed somewhat in recent years as negotiations for closer economic partnerships were initiated with India and Japan and, in 2012, Canada finally joined the TPP.

Canada's investment agreements have fared somewhat better. While only two Foreign Investment Promotion and Protection Agreements (FIPAs) are in force in Asia, concluded with the Philippines and Thailand in the 1990s, negotiations have recently been completed with China and are ongoing with India, Indonesia, Mongolia and Vietnam. Flows of FDI with these countries are minuscule, however, with the exceptions of Australia and Hong Kong.

Going forward, completion of the TPP negotiations would be the most efficient way to deepen ties with the Asian economies and to participate in a comprehensive 21st-century trade agreement that covers such issues as competition policy, government procurement and protection for intellectual property rights. Since the final agreement will require U.S. congressional approval, fast tracking is necessary so that it is subjected only to a yes-no vote and cannot be re-opened by politicians. If the TPP stalls because fast-track approval is denied, Canada should have a contingency plan for bilateral agreements, particularly with China. The huge differences in size and values and institutions between the two economies would mean a long-term commitment to gradually deepen investment and trade ties, through confidence-building agreements, in areas of mutual interest, including China's middle-class demands for more sophisticated services mentioned earlier.

INVESTMENT SCREENING AND APPROVAL POLICY: In contrast to its lagging trade strategy, Canada's policy framework for screening direct investment inflows has been, if anything, too active. Investment screening rules and procedures are controversial because of their opaque definition and application, the proliferation of thresholds that treat various classes of countries differently, and worries about the politicization of what should be an objective and transparent review process. For reasons outlined below, further changes are needed in the Investment Canada Act to simplify policy to one that focuses primarily on national security in a relatively transparent manner.

The December 2012 policy statement permitting the takeover of Canadian energy company Nexen by the Chinese SOE CNOOC Ltd., and the purchase of Canada's Progress Energy by the Malaysian SOE Petronas, complicated matters by adding further restrictions on future SOE bids for control of Canadian energy businesses. In addition to the existing net-benefit and national security tests, future bids would be allowed only under "exceptional circumstances." This policy is likely to have several negative effects: reducing competitive pressures on Canadian incumbents; increasing the cost of capital for investors and reducing investor interest by increasing uncertainties around the approval process; and raising perceived transactions cost relative to competing investment opportunities in other countries where review regimes are more transparent and predictable. The size restrictions will discourage private equity players who look to large companies for exit strategies from risky investments and deny smaller Canadian players access to the global value chains of large international players.

The new focus on ownership is ill-advised. The particular focus on SOEs reflects outdated thinking about China, where a sea change in economic policy is underway. China 1.0 of the past 35 years is being replaced by China 3.0, with a reduced role for government in the economy and a new emphasis on market efficiency — and a more competitive environment for SOEs.[19] Our focus on outdated concepts of ownership deflects us from taking responsibility for the more salient consideration: How companies, regardless of ownership, actually *behave*. We have well-established regulatory regimes ranging from competition policy to oversight of financial soundness, and monitoring for compliance with laws and regulations on treatment of labour, worker safety and environmental protection. National and provincial regulators who are mainly focused on domestic firms may lack the knowledge needed to evaluate the behaviour of firms from countries where there are different commercial rules than in Canada — but that knowledge can be learned. We should invest in supplementing regulators' knowledge bases. At the same time, business, public policy and technical schools should be offering training programs on our regulatory regimes to foreign executives, as already happens in the United States. Further, Canadian officials should be working with foreign officials to identify each other's expectations of foreign firms and to evaluate how those firms are treated. In the case of China, such joint working groups could build directly on the Canada–China Complementarities Study completed by officials from both countries in 2012.

An additional concern relates to Canadian thinking that must take better account of Asian success with global supply chains. The small- and medium-sized Canadian firms that supply these networks should not be dependent only on American supply chains, but should be accessing Asian supply chains, and should be locating their operations in Asia. Better support is needed, such as that provided by the Canada China Business Council's innovative "incubator" in Shanghai. The federal government's Global Markets Action Plan, released by Trade Minister Ed Fast in 2013, is another desirable step in the direction of correcting market failure.

In conclusion, we should be careful what we wish for. We are gaining an international reputation, rightly or wrongly, as a difficult and potentially risky place to invest. Chinese investors are moving up a learning curve. For cultural reasons, they have preferred ownership, over joint ventures and minority equity positions, as a means of control. More sophisticated investors, however, look at our assets and our policy regime and say "Why take costly risks with ownership? In the case of energy and natural resources, let us leave all the hassle of developing and transporting energy supplies to Canadian owners; let them deal with the regulatory regimes. We want the resources, so let us offer a major long-term supply contract." Foreign investors have other alternatives. Can Canada access the capital necessary to develop its natural resources on its own? That is a question that has not been answered.

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[19] Mark Leonard, "What Does the New China Think?" *China 3.0* (London: European Council on Foreign Relations, 2012): 23.

Beyond our own domestic preoccupations, Canada should be playing more of a role in the region through its institutions. Maritime disputes over territory and natural resources are heating up; our long-term interests are best served by taking whatever measures we can to head off outright conflict. Asia looms large in our future. At the same time, Asians are here to stay — as students, tourists, investors and importers. They will also become our competitors in the non-natural resources sectors of our economy. Not only do we need to get our frameworks for trade and investment right, but we must address our troublesome productivity performance to stay ahead.

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