



September 27, 2002

The domestic political challenge

China Special

Special edition for the
readers of our series
Frankfurt Voice



Editors

Maria L. Lanzani
Tel.: +49 69 910-31723
maria-leura.lanzani@db.com
Syetarn Hansakul
Tel.: +65 6423 8057
syetarn.hansakul@db.com

Publication Assistant

Bettina Giesel
Tel.: +49 69 910-31745
bettina.giesel@db.com

Deutsche Bank Research

Frankfurt am Main
Germany
Internet: www.dbresearch.com
E-mail: marketing.dbr@db.com
Fax: +49 69 910-31877

Managing Directors

Axel Siedenberg
Norbert Walter

- China's political risk has improved in several ways in the past 20 years of economic transformation, reflecting a clear shift away from a near totalitarian state and the development of a strong consensus in favour of market-oriented economic reforms.
- Despite much progress, the Chinese political system has not changed its basic structure since 1979. Political renewal has moved forward but much more needs to be done.
- The political elite faces many challenges, including the more complex and increasingly differentiated interest groups, growing diversity in social classes, and worsening income inequality.
- Aside from accommodating the interests of the newly emerging middle and professional classes, the political elite must tackle anti-government sentiment among the "losers" from the process of economic transformation, namely the rural workers and laid-off state-owned enterprise (SOE) employees.
- The Chinese Communist Party (CCP) recognises the necessity of permitting pluralism and accommodating new forces emerging in society. Future reforms may include more efforts to institutionalise the rule of law, the introduction of partially competitive and free elections, the strengthening of the Party's institutional arrangements and a higher degree of intra-party democracy.
- The adoption of the "Three Represents" ideology in the CCP's constitution signifies a decisive effort to adapt its ideology to changing times. The "Three Represents" theory widens the CCP's responsibility to represent the advanced forces of science and technology, cultural advancement and the interests of the Chinese people.
- The leadership's policy responses should be sufficient to avoid a major political cataclysm. Viewed from today it remains uncertain whether the changes will be sufficiently fast and effective. The most likely scenario is a succession of localised mini-crises, each of which can eventually be contained before too much damage is caused.

Manu Bhaskaran, Singapore, +65 9636 1056

Background and introduction

The initial article in our China Special (see “China 2020: Challenges Ahead,” August 6, 2002) provided an overview of China’s economic development as well as structural issues. The present study attempts to examine the domestic political dimensions of these developments. Specifically, it will assess:

- Where Chinese politics stands today in the context of the momentous changes in the economy and society over the past 2 decades;
- The political challenges which are emerging;
- The capacity of the Chinese Communist Party (CCP) to adapt to these changes;
- What political reforms are thus likely;
- What risks this process of political change poses for China and the world.

A report of this length cannot be comprehensive. Rather it aims to selectively analyse the key factors that help us formulate a political risk outlook for the longer term.

Our main thesis is that the Party elite recognises the necessity of permitting pluralism and accommodating new emerging forces in society. The leadership’s policy responses will be sufficient, this article argues, to avoid a major political cataclysm. But we question whether the speed and effectiveness of such changes will go far enough. Hence our view that the most likely outcome is a succession of localised mini-crises, each of which can be eventually contained before too much friction occurs.

The Party elite recognises the necessity of accommodating new emerging forces in society

Where does China’s political system stand today?

China’s political risk has improved in several ways in the past twenty years of economic transformation. The most interesting positive changes are:

- China has shifted away from being a near totalitarian state with an overwhelming ability and inclination to secure society’s total compliance with its commands. The Chinese state is now a more restrained one, where political intervention in ordinary economic and social life is less arbitrary and more limited in scope and some elements of pluralism are tolerated – in other words, it is now a more flexible and responsive political system than in the past.
- Development of a strong consensus in favour of market-oriented economic reforms downplaying the previous ideological commitment to socialism and egalitarianism. The influence of leftists who upheld such an ideology over pragmatic considerations of economic growth has been reduced substantially, allowing the pursuit of more rational economic policies which enhance the prospects for stability overall.
- The CCP has accommodated the demands from the populace for economic well-being. From being the ideologically-driven vanguard of the proletariat, it has become the pragmatic creator of material prosperity, deriving its legitimacy from the ability to deliver the economic goods to the people, rather than communism.
- The CCP has shown a capacity to weather substantial stresses – the student protests of 1986, the Tiananmen incident of 1989, the ouster of two party strongmen in 1986 and 1989, the rural unrest

China’s political system is now more flexible than in the past

associated with the economic overheating of 1993-94 and the more recent urban and rural protests. This capacity to manage and overcome problems indicates that the CCP's organisational effectiveness has recovered from the depredations of the Cultural Revolution.

However, while this represents important progress, political evolution appears to have lagged the phenomenal economic transformation of the past two decades. Despite all the economic and social changes wrought by an average 9.5% p.a. growth in 1979-2001, the Chinese political system has not changed its basic structure since 1979. This structure is marked by the characteristics depicted in what follows.

However, political evolution appears to have lagged the phenomenal economic transformation

A. The CCP continues to dominate politics in China

While there are eight "democratic" parties nominally in alliance with the CCP, this is a product of history and nobody takes these parties seriously. The CCP controls all the major organs of state power. The entire administrative apparatus of central and local government takes its instructions from the CCP. The National People's Congress, the legislative branch of government, is dominated by the CCP as well. Finally, the People's Liberation Army (PLA) retains its principal loyalty to the CCP. Its key generals and virtually all government officials hold senior positions in the CCP and accept the Party's dominance. The CCP is estimated to be 95% funded out of state funds. The overlap between the CCP and the state thus continues although efforts were made in the 1980s to reduce this. Thus, the basic structure of Party control has not changed from that instituted once the CCP consolidated control over mainland China after defeating the Nationalists in 1949.

The overlap between the CCP and the state continues

B. The CCP itself has not changed much in its inner workings

The CCP has gone through tumultuous changes since 1949, yet the basic framework of its organisation and operating procedures has changed little:

- It is still dominated by a small group at the very apex of its structure – the Standing Committee of the Political Bureau (Politburo) comprising six individuals. The Politburo itself is elected by several hundred members of the Central Committee. Even within the Politburo, the General Secretary dominates – while the current incumbent, President Jiang Zemin, cannot impose his will on his colleagues on all political issues, the Standing Committee generally defers to him on non-sensitive matters. The General Secretary continues to have substantial say over key appointments such as the head of the CCP's Organisation Department which controls personnel matters in the Party. For instance, President Jiang has been able to appoint his protégé Zeng Qinghong to head the Organisation Department despite the latter's unpopularity among several senior leaders.
- Intra-party democracy is still limited. There are no competitive elections to nominate persons to the levels of central committee members and higher although a few moves are being made at lower levels (see below).
- The CCP's alliance with the PLA continues to be a vital determinant of its hold on power. The CCP controls the PLA through the Central Military Commission which is currently headed by President Jiang. Senior military commanders hold key appointments at Politburo and

The CCP is still dominated by a small group at the very apex of its structure – the Politburo

Intra-party democracy is still limited

Central Committee levels. The PLA has been the ultimate arbiter in intra-party power struggles – not only during the Cultural Revolution and its immediate aftermath but also later. The PLA's role was critical in the power struggle preceding the Tiananmen incident in 1989 and again in Jiang's move against his rivals, the Yang brothers in the early 1990s.

C. A mass political culture which – so far – defers to the authority of the CCP

Traditional Chinese philosophical thought has upheld deference to authority and placed tremendous emphasis on order and stability rather than freedom. The collective good is generally held to be much more important than individual rights or liberty. There is no great yearning for democracy along Western lines in the mass of average Chinese and even within a substantial part of the intelligentsia.¹

The table on this page summarises some of the findings of a survey in China which attests to a significant degree of pragmatism among the general populace, with a premium placed on prosperity and less on democracy. Some points stand out from the table:

- Across all age groups, there is scant interest in "political democracy". Even among the young, who are presumably much more exposed to Western ideals, the proportion seeking democracy is unusually low, while most place a high priority on national peace and prosperity. In other words – so long as the CCP delivers the economic goods and ensures peace, people are prepared to forego democracy.
- Individual freedom – the latitude for an individual to conduct himself/herself with minimal intervention from the state – is clearly valued. This and the yearning for "fair justice" probably reflect the aversion to the arbitrariness and injustice of the Cultural Revolution years (1966-76). The CCP understands these yearnings and has tried to accommodate them. For example, it does not impose Maoist styles of dress and personal behaviour anymore. And it is working to improve the judicial processes.

There is no great yearning for democracy along Western lines in the mass of average Chinese

Across all age groups, there is scarce interest in "political democracy"

But individual freedom is clearly valued

Survey of Beijing residents, 1995: What do you value most?

% of answers in each age group

Age group	Individual freedom	Public order	Fair justice	Social equality	Political democracy	National peace & prosperity	Don't know
18-25	13.3	5.0	16.7	10.0	5.0	48.3	1.7
26-34	8.5	2.8	18.6	10.7	0.6	58.8	0.0
35-44	5.8	3.9	11.0	13.3	5.2	59.5	1.3
45-54	4.4	7.4	14.8	6.7	10.4	55.6	0.7
55-64	4.2	6.3	9.9	5.6	7.7	55.6	10.6
65-74	4.5	4.5	9.0	9.0	9.0	44.9	19.1
All	6.3	4.7	13.0	10.0	5.8	56.0	4.2

Source: Dowd et al (op.cit.)

¹ Daniel Dowd, Allen Carlson and Shen Mingming, The Prospects for Democratization in China, in Zhao Suisheng (ed.), China and Democracy, Routledge, 2000.

D. Political renewal has improved but still remains a major risk factor

The CCP has made great strides since the Mao Zedong era when Mao appointed successors arbitrarily. Leadership changes are now undertaken in a more structured manner in line with the Party constitution, and with several groups within the Politburo, Central Committee and the PLA having a say. Differences are ironed out well in advance of any key decisions.

Most interestingly, party leaders have evolved a tradition that the losers in any power struggle will not suffer undue punishment. This was seen most recently when Qiao Shi, a powerful challenger to Jiang Zemin gracefully surrendered his positions and retired quietly in 1997. Zhao Ziyang who lost his bid for power against Deng Xiaoping in 1989 has lived comfortably under a relaxed form of house arrest since 1989. This is a major advance on the Cultural Revolution and its aftermath when opponents were killed or given suspended death sentences or were jailed for life.

These improvements reduce the risks of disruptive political changes. Nevertheless, leadership selection continues to be marked by a non-transparent process of behind-the-scenes manoeuvring. In this process, certain groups such as retired Party elders, PLA generals and provincial power brokers have more say than the Central Committee of the CCP. The National People's Congress (NPC) which, as the national legislature, should decide on the nation's political leadership, has little say, even indirectly. Differences over the succession to Jiang Zemin were reportedly ironed out by a small coterie of CCP and PLA leaders at the annual summer conclave of the political elite at Beidaihe in July/August – not by a meeting of the CCP's Central Committee and certainly not by parliamentarians of the NPC.

The question is whether this system is sustainable and where it is heading. To answer this, we need to assess the nature of the challenges China faces in coming years.

The rising challenges facing the political elite

China's political system has to accommodate multiple challenges arising from the economic transformation. Here, we focus on those with the greatest political implications.

A. Economic development has created a more complex and more highly differentiated set of interest groups

A recent study by the Chinese Academy of Social Sciences (CASS) assesses that many new social strata have developed in the reform period, defined by their ability to command political, economic and cultural resources. Unlike in 1979 when two-thirds of the population were rural workers, we now have in China a range of different classes, each with its own interests to accommodate and each much larger than before (see table on the next page).

The CASS study estimated that the middle class represented 15% of the working population. While this is small compared to the 60% equivalent figure in the US, it amounts to 110 m people or half of the urban population. While projections of how this class will grow vary, all but a handful agree that the middle class will grow substantially. Trade Minister Long Yongtu estimated 400-500 m Chinese would enjoy middle-income status by 2011. The State Information Centre estimated

Leadership changes are now undertaken in a more structured manner

But leadership selection continues to be a non-transparent process of behind-the-scenes manoeuvring

Unlike in 1979, we now have a range of different classes

Class formation in China 1952 - 1999

Class	1952	1978	1988	1999
composition of China's workforce, %				
Administrators/Managers	0.6	1.2	2.2	3.6
Owners of private enterprises (1)	0.2	0.0	0.0	0.6
Owners of private enterprises (2)	4.1	0.0	3.1	4.2
Technicians/specialists	0.9	3.5	4.8	5.1
Office workers	0.5	1.3	1.7	4.8
Business/service workers	3.1	2.2	6.4	12.0
Manufacturing workers	6.4	19.8	22.4	22.6
Agricultural workers	84.2	67.4	55.8	44.0
Unemployed/under-employed	n.a.	4.6	3.6	3.1

Source: The Economist, quoting paper by Chinese Academy of Social Sciences entitled "Report on a study of contemporary China's social strata"; January 17, 2002

Notes: (1) 8 or more employees (2) Fewer than 8 employees

that by 2005 China would have 200 m middle-income consumers, defined as those who could afford to buy cars and houses and take leisure travel.

Growth of the urbanised middle class is usually a harbinger of political change. Not surprisingly then, the CCP's Organisation Department in a May 2001 report noted that "as the economic standing of the affluent class has increased, so too has their desire for greater political standing".

By 2005, it is estimated that China would have 200 m middle-income consumers

B. Growing diversity in social classes is associated with increasing income inequality, which generates resentment

Interestingly, despite the rise of the middle class, inequality has grown. The *China Investigation Report* (a publication of the CCP released in May 2002 and then hastily withdrawn) notes that the Gini coefficient – a measure of income disparities with 0 suggesting total equality and 1 total inequality – has climbed from 0.389 to 0.397 in only four years (1995-1999). In rural areas, the Gini coefficient is between 0.3 and 0.4 in fifteen provinces. Internal Party documents suggest that the CCP considers a Gini coefficient of 0.4 as the danger line for social resentment. A recent internal CCP document revealed that 59% of workers and staff complained that the status of workers had declined in China.

Despite the rise of the middle class, inequality has grown

C. The unevenness of economic development is creating large classes of people who are losers from economic change and who need to be accommodated

According to Wang Dongjin, China's Vice-Minister of Labour and Social Security, China can create 8 m jobs p.a. if it achieves 7% growth a year. This lags behind the demand for 20 m new jobs a year for the next four years as a result of (a) 150 m surplus rural workers; (b) 12-13 m new additions to workforce p.a.; (c) 6.8 m stock of unemployed workers as of end-2001; (d) state-owned enterprise (SOE) lay-offs of around 5 m p.a. In other words, barring a miraculous rate of GDP growth, unemployment must increase.

Barring a miraculous rate of GDP growth, unemployment must increase

There are two classes of losers from this – rural workers and SOE employees.

- The rural sector is likely to be the largest. Already, of the 150 m estimated surplus workers in the rural sector, about 80 m roam around the country looking for work. Given that agricultural prices in China are higher than world prices, China's increased integration into the world economy post-WTO accession must mean that farmers' incomes come under even greater pressure. In many cases, their incomes will probably fall to levels low enough to prompt many more rural folk to migrate to the urban areas.
- The number of urban workers laid off by SOEs will not be far behind those in the rural sector. As China integrates with the global economy, industrial rationalisation becomes unavoidable. About one-quarter of the state-owned enterprise (SOE) labour force (over 26 m workers) has been laid off over the past four years. Estimates of unemployment are as high as 20 m by 2006 compared to 6.8 m today. But if one includes 12 m laid-off workers who are only considered employed because they receive an allowance from their SOEs, then the actual unemployment situation is a lot worse.

Unemployment in the rural sector is likely to be the largest

One-quarter of the SOE labour force has been laid off over the past four years

D. There is greater public cynicism and losers are showing signs of greater willingness to take direct action to vent their anger

A survey commissioned by the State Commission on Reform of the Economic Structure in 1998 revealed that 80.6% of people were dissatisfied with the growing gap between rich and poor. Survey responses suggested that the idea of getting wealthy legally was widely ridiculed. A total of 87% expressed considerable concern about the social situation. Corruption was cited as a prominent concern, but no figures were given. In conclusion, the survey stated, "One cannot be optimistic about the attitudes of workers."

People are dissatisfied with the growing gap between rich and poor

There have been several large protests of late. In Daqing earlier this year, huge protests were mounted against PetroChina by workers dissatisfied with redundancy packages. Protests lasted several days, with up to 20,000 protestors participating at one stage. There were protests of a similar scale in Liaoyang city in Liaoning as well at around the same time. Smaller demonstrations, sometimes violent, have been reported, e.g. in Fushun, Dongguan and in Szechuan province as well. There was even a small demonstration in Beijing city centre by laid-off workers in late March.

There have been several large protests of late

E. The central authorities are facing greater dissatisfaction in minority areas

A major area of concern is the western province of Xinjiang, bordering on the Turkic-speaking and largely Muslim Central Asian republics. Xinjiang has a substantial population of Uighurs, Uzbeks, and other Turkic peoples – 60% of the population are Muslims. Poverty tends to be concentrated among the minorities. Such inequalities fuel sentiment against the majority Han Chinese. Worse still, the reform process has reportedly exacerbated ethnic tensions because private enterprises (mainly Han-run) tend to lay off non-Han employees. Religious tensions are also serious and growing.

A major area of concern is the western province of Xinjiang

In conclusion: the challenges facing the Chinese political system are immense. First, it has to accommodate the interests of the newly emerging middle and professional classes in society. Second, it has to tackle anti-government sentiments of each set of "losers", be they laid-off workers or minorities. Third, it has to mediate between the

China has to tackle anti-government sentiment of "losers" ...

clashing interests of rural folks desperate to earn a living by migrating to towns and those of urban residents who resent this increased competition for jobs. The scale of the problem is growing and it will become increasingly difficult to rely on extraordinarily high growth to alleviate political risks because of a basic dilemma: the pursuit of high growth requires either further economic rationalisation (which raises unemployment initially) or it entails potentially destabilising fiscal deficits or monetary expansion.

The question then is whether the CCP can adapt itself to successfully contain these problems.

Can the system cope?

The critical and determining element of the political system is the CCP. Whether the system as a whole can cope with the scale of challenges described above therefore turns on the organisational capacity of the CCP to adapt itself to the changing environment. We first examine weaknesses that have emerged in the CCP as an institution and then look at the CCP's capacity to adapt and conclude that it appears to be demonstrating an ability to overcome the external challenges as well as internal weaknesses.

A. Weaknesses of the CCP

1. The CCP is not as attractive to the populace as before: while CCP membership has grown to 64 m from 50 m in 1990, there are indications that the CCP has not been able to respond to the unfavourable trends. By end-2000, the non-state sector had grown to account for 50.9% of industrial output. As state ownership and control over the economy declines, the ability of the CCP to woo members has fallen sharply. There appears to be a correlation between the falling percentage of the labour force working in SOEs and membership in the CCP, showing that the CCP is failing to win over workers in the private sector (see table on the next page). For instance,
 - In Wuhan (population 4.4 m) in 1993, 0.9% of CCP members worked in private or foreign firms. By 1999, the percentage had not risen.
 - In Shenyang in 1999, 640,000 worked in the non-state sector but only 29 of them were members of the CCP. Only 17% of private firms employed CCP members in 1999 and just 3% had any kind of party organisation.
 - In foreign joint ventures with SOEs, only 35% employed CCP members and only 17% had party cells.
 - Shanghai, at the end of 1998 had only 353 party organisations in private enterprises and seventy-four in foreign invested enterprises – representing just 0.43% and 3.35% of those sectors.

Party organisations at the grassroots levels appear to be decaying, with party activities ceasing in many cases. Another problem for the Party in attracting members is that at the local level, it has become less relevant since the household responsibility system was adopted in the early 1980s. This system was introduced in the first wave of reforms and radically altered the rural production system. The system essentially leased land to farmers who then had the latitude to conduct profitable farming with less intervention from local Party officials. Thus, the role of the Party officials in

... and to mediate between the clashing interests of rural folks and those of urban residents

The CCP itself must adapt

The CCP is not as attractive to the populace as before

Party organisations at the grassroots levels appear to be decaying

determining farmers' livelihood was reduced. As reforms progressed, the Party's role in the day-to-day life of ordinary folks has diminished.

2. The commitment of CCP members to the Party has weakened: economic reforms caused the gradual erosion of the relative social standing and power of the local Party secretaries, and also reduced their income advantages. All this while the complexity and difficulty of their tasks has increased. The issue of incentive has emerged for talented people to remain party secretaries/officials. The Party is finding it increasingly difficult to retain cadres. For instance, a survey carried out in Tonghua City in Jilin province found that three leading municipal-level cadres and 12 leading county-level cadres had resigned their positions to go into business since 1992.
3. The CCP has become associated more and more with the elites rather than with the proletariat and rural folks of its original raison d'être: the CASS study shows that the wealthiest class – that of state and society administrators – is almost totally dominated by CCP members. Other research² estimated that most of the Party's 65 m members have landed themselves in the top 10% of the population with incomes greater than RMB 300,000. Reflecting the greater influence of the wealthy elites in the CCP, this year's Labour Hero awards went to 4 entrepreneurs while 17 businessmen were honoured as "model workers".
4. The CCP's alliance with the PLA may have come under some strain: two recent developments have caused some tension in CCP-PLA relations:

The commitment of the CCP members to the Party has weakened

The CCP has become associated more and more with the elites

The CCP alliance with the PLA might have come under some strain

Social class of CCP membership

Social class	CCP membership		CYL membership ⁽¹⁾	
	Highest	Lowest	Highest	Lowest
Percentage of CCP/CYL membership in various social classes % ⁽²⁾				
State and society Administrators	100	77.5	100	90
Managers	58.8	35.7	97.1	61.5
Private entrepreneurs	24.4	9.1	85.2	45.5
Technical experts	27.2	17.8	88.2	67.3
General officers	54.5	28.2	87.4	46.3
Individual private businessmen	13.7	5.2	60.8	11.8
Commerce & service workers	10.6	3.9	68.3	28.8
Industrial workers	13.3	6.0	72.9	21.6
Agricultural workers	5.2	4.3	23.9	10.2
Unemployed	9.1	1.8	58.3	9.1

Source: Report on the Study of Social Classes in Contemporary China by the Chinese Academy of Social Sciences (CASS), quoted in the Straits Times, May 15, 2002

Notes: (1) CYL is the Communist Youth League, the youth wing of the CCP

(2) Percentages refer to % of those in each class who are party members e.g. 9% to 24% of private entrepreneurs are party members.

² Study by He Qinglian quoted in Straits Times Singapore, May 15, 2002

- First, the CCP's decision in 1998 to force the PLA to divest itself of all its commercial operations caused a significant degree of annoyance at the implementation level – even though the top-most PLA leadership and many professional officers agreed with the policy's aim of reducing corruption and improving discipline. PLA officers and civilians fought over the level of compensation, the value of the PLA's various assets, and the criminal pursuit of high-ranking military officers accused of corruption. Mini-crises over the budget were only resolved by the NATO war in the Balkans, which greatly strengthened the hand of the PLA in key long-term budget programming meetings in the spring of 1999 and reduced the temperature of the conflict surrounding divestiture from that point forward.³
- Second, the PLA's apparent control over and manipulation of the details in the EP-3 crisis⁴ further strained bonds of trust between civilian elites and the military. The civilian leadership felt that the PLA had selectively disclosed information causing them to misjudge the situation and force an unnecessary confrontation with the US.

Jiang Zemin's heir-presumptive Hu Jintao, who was in charge of the divestiture process, is reported to have had several differences with the PLA as a result. The Hu generation of CCP leaders have even less of a relationship with the senior PLA than Jiang had. Hu's differences with the PLA officers in this episode will not help future CCP-PLA relations.

Hu Jintao, who was in charge of the divestiture process, is reported to have had several differences with the PLA

B. Despite the weaknesses, adjustments seem underway

Nevertheless, the CCP has overcome these deficiencies sufficiently to take the initiative in several key areas. This suggests that its weaknesses are balanced by a capacity to adapt and evolve responses to the challenging environment.

1. The CCP is making decisive efforts to adapt its ideology to changing times: Jiang Zemin's proposed "Three Represents" theory has now been incorporated into the CCP's constitution. This theory tries to modernise the CCP's mission, shifting it away from being the vanguard of the proletariat to "representing" the advanced forces of science and technology, those of cultural advancement and the interests of the Chinese people. Jiang has also raised questions over the Marxist theory of surplus value – the very basis of the view that capitalism exploits workers. This suggests that the "Three Represents" theory is only just the beginning of a longer process where the CCP will update its ideological underpinnings to make it more relevant to the new age. These ideological reforms pave the way for the CCP to make other reforms discussed below.
2. The CCP is making efforts to co-opt new forces in society: Jiang's proposal to induct businessmen into the party as members was highly controversial but this simply validates a process that has been underway for some time, with the first step having been taken by Jiang's predecessor Zhao Ziyang in 1987. The ideological re-

The "Three Represents" theory has been incorporated into the CCP's constitution

The CCP is trying hard to co-opt new forces in society

³ James Mulvenon, PLA Divestiture and Civil-Military Relations: Implications for the Sixteenth Party Congress Leadership, China Leadership Monitor, December 2001.

⁴ The EP-3 crisis was precipitated by the clash near Chinese territorial waters between a US Air Force EP-3 and a Chinese fighter aircraft in which the Chinese aircraft crashed, killing the pilot.

thinking will pave the way for more private businessmen to enter the party, infusing it with more talent and ideas as well as allowing it to be more representative of, and therefore more relevant to, the new China.

3. The authorities have dabbled in democratic elections at the grassroots levels: they have tolerated a limited and creeping process of democratisation. Although only about a third of China's one million villages have held elections for the posts of village chief and committee members, the law has permitted such elections for a decade. For those villages which have experienced multiple rounds of elections (some as many as four), academic work suggests that the nomination process is becoming fairer and more open, thus loosening the CCP's monopoly on village administration.⁵ A number of urban areas have also allowed elections to neighbourhood residential associations – though unlike the village committees, these associations have little power over the lives of urban residents.

More interestingly, the CCP is experimenting with inner-party democracy – again, only at the local grassroots level. The CCP leadership appears to have realised that promoting cadres who are acceptable to their local constituency, can reduce the growing conflicts between party secretaries and government leaders and increase the accountability of local party leaders. This addresses the tension between local cadres and the public caused by the monopoly of power that local party leaders have enjoyed and the inevitable abuses of that power.

4. The authorities have managed local protests more intelligently than before: unlike past heavy-handed and brutal reactions, security forces have managed recent large-scale protests with care. Concessions were made, grievances addressed and only a few people were actually arrested. In this way, the likelihood of local protests escalating into larger nationwide protests feeding on political mishandling has been reduced. This argues for greater stability despite occasional outbreaks of protest.

In conclusion: clearly, the CCP is not sitting still. It has diminished in organisational strength in some ways but still exhibits a capacity for internal reform and to adjust itself, even in ways which are controversial and uncomfortable such as the ideological changes mentioned above. The question then is not so much whether the CCP and government will reform politics, but how.

What are the likely reforms?

A. China is entering a period of faster political change

The above analysis suggests the following pattern of political change in coming years:

First, the Hu Jintao generation of leaders was supposed to take over party positions by November 2002 and government posts by March 2003, although uncertainty about the concrete take-over dates has recently mounted. Aware of the unfavourable challenges described above, and less burdened by ideological baggage, the new generation of leaders will be better positioned to push for faster and bolder change.

The authorities have dabbled in democratic elections at the grassroots levels ...

... and managed local protests more intelligently than before

The Hu Jintao generation of leaders was supposed to take over party positions by November 2002 and government posts by March 2003

⁵ Larry Diamond, Foreword in Zhao Suisheng (ed), op.cit.

Second, the CCP retains its dominant position in society and does not face the sort of loss of popular confidence that presages a revolutionary upsurge that could oust it or force it to undertake reforms against its will. The political changes to come will therefore be largely driven by the CCP for the coming few years.

Third, the broad areas where change is likely are also clear from publicly available party documents. The CCP recognises that China must develop the rule of law, accommodate new social classes, co-opt talent and leaders from these new social classes and increase transparency and competition in the selection of local Party cadres in order to meet the political challenge it faces today.

Fourth, while the new generation of leaders is less ideological in its approach, they are still the products of their own experience. Thus, they will probably view politics through the prism of the major earthquakes they endured: the mid-1960s Cultural Revolution, the 1986-89 student protests that culminated in the Tiananmen tragedy and the 1991 collapse of the Soviet Union. Even this generation of Chinese leaders will remain averse to uncontrolled political liberalisation, radical change and any risk of mass political action. Change will not be too radical, or too liberal in nature.

B. Reforms at national or social level

First, there will be more efforts to institutionalise the rule of law. Already this is emerging – citizens are now able to use the law effectively against higher authority, with more than a third of such cases leading to some form of relief for the plaintiffs either through a court decision or through out-of-court settlement.

Second, the Chinese leaders are likely to allow the National People's Congress and its provincial equivalents to become more autonomous. It is possible that the NPC will be allowed to conduct inquiries and hearings in some important matters, for instance.

Third, the introduction of partially competitive and free elections will be extended through the village level and expanded to larger administrative jurisdictions. However, it is unlikely to be extended to the provincial level – here the size of the electorate is so large that different factions resembling alternative political parties would tend to form. This is still anathema to the CCP.

Fourth, the authorities are likely to tolerate a moderately freer press so long as investigative reporting and critical commentary steers clear of attacking the national leadership. The room given to independent and activist business papers such as *Caijing* suggests that the authorities appreciate the role of a slightly freer press in exposing local-level wrongdoing and acting as a vent to popular frustration.

Another key area is the growth of civil society. We believe the CCP realises that it needs to allow independent social organisations to operate and give citizens' groups increased input in policymaking. The CCP will be recognising and legitimising what is already happening, with many semi-official and private groups of lawyers, private entrepreneurs, consumers and environmentalists emerging.

Finally, the CCP also realises that it needs to keep the PLA on side so that civilian pre-eminence continues. We believe that the leadership will buy off the PLA by adopting a highly nationalistic profile and stepping up defence spending. This way, it would hope to focus the PLA leadership's activities on national security and not on domestic politics.

The CCP retains its dominant position in society ...

... and recognises that China must develop the rule of law

The new generation of leaders will remain averse to uncontrolled political liberalisation

There will be more efforts to institutionalise the rule of law

The introduction of partially competitive free elections will be extended

Another key area is the growth of civil society

C. Reforms at party level

The Chinese leadership is likely to continue reforms aimed at strengthening the Party's institutional arrangements and tolerating some degree of intra-party democracy, such as the regular convening of party congresses, tolerating moderate grassroots influence over the nomination of delegates to party congresses and allowing congresses to decide their own agenda. A recent Party document written by a conservative leader advocated the need to greatly expand inner-party democracy by having multiple-candidate elections for some official posts, suggesting that there is a broader consensus for intra-party reform than thought.

Reforms might also include establishing a party congress standing committee system, similar to that in the National People's Congress so that decision-making between Party congresses is not entirely left to a small group in the Politburo. A system of party hearings to consider different views when the Party is contemplating major issues (such as revising the Party charter) is also possible.

So, it is not likely that China will become a Western-style democracy in the next decade or so – with multiple parties competing on a level playing field and considerable room for expressing contentious political ideas. Political reform will be incremental, with any reform measure tested out in pilot projects in one or two provinces and the results studied and debated at length before being implemented nationally.

Conclusion: the political risks ahead

In essence, this article argues that the baseline scenario is that, while political challenges mount, the system's capacity to manage these challenges will improve sufficiently to avoid any generalised, nation-wide political crisis – even if the CCP does not permit substantial democratisation. This view is supported by:

- The CCP's capacity to reform itself. It is evolving from an ideologically driven party of the proletariat determined to create socialism towards a pragmatic party representing a wide array of social forces. Its pragmatism will probably help it to deliver the economic and social goods to the people at a pace sufficient to maintain the people's acquiescence with the political system built around the CCP.
- The accommodation of the middle classes and the intelligentsia through "creeping democratisation" restricted to local levels that impinge on the direct day-to-day interests of the people should help contain political instability as well. In particular, the middle class, being a big winner from economic growth, is unlikely to take on the CCP and risk destabilising the system they derive so many benefits from.
- The political culture of deference to authority, pragmatic emphasis on material well-being rather than high-flown ideals and yearning for order and stability are also critical factors that help the CCP maintain its dominance in the political system.
- A greater sense of national pride emerging from China's vigorous return to global eminence and the dominance of the Han ethnic group will reduce any chance of provinces or regions attempting to split away outside Xinjiang and Tibet where the Hans are not yet dominant. Even in these two areas, suppression of independence movements, the lack of external support for insurgency and growing Han Chinese settlement activities mean that breakaway provinces

The Chinese leadership is likely to strengthen the Party's institutional arrangements

It is not likely that China will become a Western-style democracy in the next decade or so

The system's capacity to manage challenges will likely avoid any generalised nation-wide crisis

The middle class is unlikely to take on the CCP and risk destabilising the system

Han dominance will reduce the chance of regions attempting to split away

are not likely. In the rest of China, the CCP and PLA networks will ensure that provincial leaders are not able to build power bases which give them too much independence.

Nevertheless, the multiple challenges deriving from the increased complexity of society and weaknesses in the CCP-dominated system such as corruption, abuse of power and over-centralisation of decision-making do mean that the political system might not escape from occasional bouts of instability, taking the following forms:

- A higher risk of leadership infighting post-Jiang. Infighting has been a feature of the Communist era but what will be different is the absence of a set of revered elders who could impose a settlement. The greater autonomy granted to the NPC and party organs means that a putative rival now has more platforms from which to mount a challenge. And the proliferation of civil society organisations means that such a rival could ally himself with these non-CCP forces.
- Localised large-scale protests and demonstrations in the northeast industrial belt and other areas where there is both a concentration of state enterprises as well as heavy industry.
- Similar problems at the village level, as the CCP has not shown itself able to effectively address local-level corruption and abuse of power.
- A higher chance of social disorder – rising crime, growth of disruptive religious or other sects, etc – as unemployment rises and migration (which disrupts social bonds) continues at an even more rapid pace.
- China's economic successes and the leadership's interest in using nationalism will inevitably give rise to a more aggressive form of Chinese nationalism.
- Given the need to maintain high rates of growth to prevent political dissatisfaction from getting out of control, it is highly unlikely that China's leaders will markedly change policies towards foreign investors. Provincial leaders however might attempt to use local regulations to promote the interests of local enterprises over foreign ones. Thus local protectionism is a greater risk for foreign investors than national policies.

What could cause worst-case scenarios to unfold? For political risks to rise beyond the localised bouts of instability outlined above, the following conditions would have to fall in place:

- The structural weaknesses in the economy turn out to be substantially worse than forecast. If economic growth falls below 6%, unemployment will rise and the CCP's capacity to deliver the economic goods will be compromised, thus reducing the main source of its legitimacy.
- If leadership infighting worsens and rival factions form which then seek to ally with forces outside the CCP or exploit social disorder for their own purposes, then the CCP's ability to maintain its grip could weaken.

While we cannot dismiss the chances of such risks actually materialising, we would rate the chances of these extreme scenarios at less than 15%.

Manu Bhaskaran*, Singapore, +65 9636 1056

*Guest author

The political system might not escape from occasional bouts of instability

Local protectionism is a greater risk for foreign investors than national policies

A worst-case scenario would develop if structural weaknesses were worse than expected and the CCP lost its grip on power

Deutsche Bank Research



January 15, 2003

China as potential superpower: regional responses

China Special

Special edition for the
readers of our series
Frankfurt Voice



Editors

Maria L. Lanzani
Tel.: +49 69 910-31723
maria-laura.lanzani@db.com

Syetarn Hansakul
Tel.: +65 6423 8057
syetarn.hansakul@db.com

Publication Assistant

Bettina Giesel
Tel.: +49 69 910-31745
bettina.giesel@db.com

Deutsche Bank Research

Frankfurt am Main
Germany

Internet: www.dbresearch.com

E-mail: marketing.dbr@db.com

Fax: +49 69 910-31877

Managing Director

Norbert Walter

- China's rising economic and political power has profound impacts and implications on the rest of Asia. However, to say that China is growing at the expense of the rest of Asia is too simplistic. China's emergence creates threats as well as opportunities for the rest of Asia. The countries, sectors and companies which get their basics right will benefit, while others, which don't, could suffer from China's emergence as a regional superpower.
- In terms of growth in FDI and exports, empirical evidence suggests that some Asian economies have gained while others have lost, which may not necessarily be attributable to the China's emergence factor. In addition, China's – emergence has had many positive impacts on the rest of Asia, e.g. as a potential market and as a potential investor.
- China will continue to benefit from the World Trade Organization (WTO). However, China's gains may be best understood in terms of a portfolio approach, which suggests that there is a finite limit to China's increased market share in FDI and exports. Further ahead, more painful reforms to tackle long-deferred problems in China will lead to stresses and strains in its economy. Thus, China's relative attractiveness as a destination for FDI may also be affected.
- The Asian region has responded with increasing vigour to China's emergence, at both the macro and micro levels. At the macro level, although the quality of policy responses has varied from country to country, the responses have been largely positive. At the micro level, corporate restructuring by domestic companies has helped boost competitiveness to a certain extent, although admittedly Asian companies still have a long way to go to achieve maximum efficiency. The bottom line is that the rest of Asia is not passive in the face of China's recent emergence.
- The rise of China impacts the global and regional geo-political framework. Among other things, China's relative economic weight in the region will rise (it is already the largest economy in terms of nominal GDP size in non-Japan Asia). China's economic growth will potentially help it fund a massive expansion in military spending. China is thus likely to become much more powerful in relation to Japan and other Asian countries.
- China's political and security ambitions dominate over economics, with economics being a means to larger strategic goals. Nevertheless, China's political-security moves will probably be marked by a benign and pragmatic approach. China is not likely to provoke a security crisis in Asia.
- In summary, China's emergence as an economic and political superpower will likely change the economic division of labour in Asia, but that does not mean other countries must always lose out. Adjustment is the key. At the same time China's emergence will also create a new geo-strategic balance in Asia and the world.

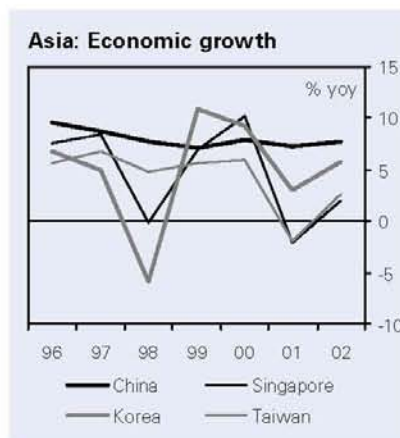
Article contributed by **Manu Bhaskaran**, Centennial Asia Advisors Pte Ltd., Singapore (Tel. +65 9636 1056). Guest authors express their own opinion, which is not necessarily that of Deutsche Bank Research.

Introduction and summary

This article addresses the question, "What does China's rising economic and political power mean for the rest of Asia?" Specifically, will China grow at the expense of the rest of Asia? What are the strategic consequences? And what are the policy responses as well as the adjustments set in train by the impact of China?

In summary, our views are that:

- China's emergence is producing a new division of labour and a new pattern of winners and losers in Asia. To say that China is growing at the expense of the rest of Asia is too simplistic and does not capture the complex processes at work. China's emergence creates both threats and opportunities for the rest of Asia. It is probably more accurate to say that those countries, sectors and companies which get their basics right will benefit and the others will suffer.
- Second, the rest of Asia is responding with increasing vigour to China's emergence. Reforms are being intensified at the macro-policy level while companies are also restructuring at the micro-corporate level in order to adjust to the competitiveness shock caused not just by China but also by spreading globalisation.
- Finally, China's rise impacts the geo-political framework. China is not following a purely economic agenda as Japan did. Its political and security ambitions dominate over economics, economics being a means to larger strategic goals.



Is China's growth at the expense of the rest of Asia?

The evidence appears to suggest that the view that China's growth is at the expense of others in Asia is probably not accurate:

- China's faster growth in foreign direct investment (FDI) compared with others leads many to conclude that China must be diverting FDI away from its neighbours. However, in order to identify the impact of China rather than other factors, we need to adjust for countries such as Indonesia which have experienced substantial crises. Once this is done, the "China" impact does not appear to be so damaging.
- Since export market shares must add up to 100%, China's rising share of global exports must come at the expense of others. But this higher share comes mainly at the expense of Hong Kong, Taiwan and Japan – i.e. places where production is being relocated as an integral part of moving up the value chain. Other competitors have not seen their market share dwindle significantly.
- China is also having a growing positive impact on the economies of the region – through rising demand for the region's exports of goods and tourist services. China is also beginning to emerge as a foreign investor in many countries.

Evidence suggests China is not growing at others' expense

There is also a positive impact of China's emergence

A. Impact on foreign direct investment

To judge the impact China is having on flows of FDI into Asia, we need to make two adjustments. First, Indonesia's political convulsions have damaged investor confidence independently of any impact China's improving fundamentals (e.g. accession to the WTO) have on investor preferences. If one excludes Indonesia, Southeast Asia – seen by many to be the main loser from China's emergence – is found to be still attracting reasonable amounts of FDI despite China and the damage wrought by the Asian financial crisis.

Foreign direct investment in China

	1984-89	1990-94	1995-99
USD billion	2.3	16.1	40.6
% of China's GDP	0.7	3.7	4.7
China's share of total FDI in developing countries (%)	12.7	27.1	23.3
Estimate of "round-tripping" ¹⁾	n.a.	25% (1992)	7% (1996)

¹⁾ Round-tripping consists of local Chinese enterprises sending money abroad illegally and bringing it back in the guise of foreign direct investment in order to benefit from government incentives meant for foreign investors and to gain added protection for property rights which favour foreigners.

Source: IMF Policy Discussion Paper PDP/02/3, "FDI in China: Some Lessons for other Countries" by Wanda Tseng and Harm Zebregs, February 2002.

Second, Chinese companies regularly route investment via an offshore company which is then designated as "foreign" (the so-called "round-tripping"). They do so because (a) foreigners' property rights are better protected; and (b) foreigners get better investment incentives from the government. So, what is essentially domestic investment appears in the data as foreign, exaggerating China's FDI. The table above provides some estimates suggesting that "round-tripping" is large, i.e. the true level of FDI entering China is substantially less than the reported figures suggest.

The table below provides a more detailed picture of China's impact.

Is China really diverting FDI away from other Asian economies?

% of total Asia (ex HK) net FDI ¹⁾	1995	2000 ²⁾	Remarks
China	53.0	54.2	Steady rise through 1990s
Taiwan	2.3	6.5	Sharp rise since Asian financial crisis
Korea	2.0	13.6	Surged following liberalisation
Southeast Asia	35.1	18.3	
Southeast Asia ex Indonesia	28.6	24.4	Adjusted for Indonesia, decline is not huge
Indonesia	6.4	-6.1	Negative numbers skew SE Asian data
Malaysia	8.6	7.3	Remarkably steady – so far
Philippines	2.2	2.0	Remarkably steady
Singapore	10.7	8.5	Falling modestly in relative terms
Thailand	3.0	3.2	Remarkably steady
India	3.2	3.1	Continues to under-perform

¹⁾ Hong Kong is excluded as its FDI numbers are highly volatile and distort the analysis.

²⁾ Year 2000 is chosen as consistent, year-2001 data are unavailable.

Source: Asian Development Bank (website)

An analysis of how each country is faring also brings out some interesting facets of FDI in Asia.

China. Even without adjustment, the rate at which its share of FDI has grown appears to be peaking. China's share of global FDI rose most in the early 1990s. The data for 2002 so far suggest a continued surge – a result of the enthusiasm for China sparked off by its accession to the WTO. The more recent surge has also been driven by FDI from Taiwan and Japan, reflecting production relocation in order to reduce costs.

South Korea has raised its share of FDI, suggesting that China is not the only winner. South Korea's liberalisation started in the early 1990s and accelerated after the financial crisis. Substantial FDI has entered the country, most of which has been in the form of acquisitions of large stakes in existing businesses rather than greenfield investment in new plants as has been the case elsewhere.

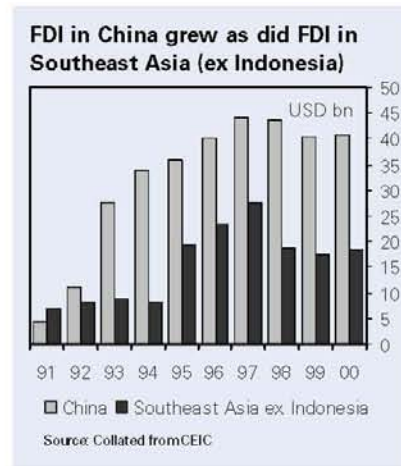
Taiwan has also increased its share of FDI. This again shows how countries which were previously closed and which have good fundamentals do attract FDI. Taiwan's technology sector has attracted substantial inward investment. An additional factor that is critical to Taiwan's ability to attract FDI has been the high rate of innovation in the economy, particularly in the technology sector. Taiwan was ranked 4th in the world in terms of patents issued in 2000 compared with 11th position in 1990. (Source: US Patents & Trademarks Office)

Thailand. Thai balance of payments data shows that annual average FDI in Thailand has roughly doubled since the mid-1990s and is stabilising at around USD 2.8-3 bn a year, reasonably good for an economy still suffering from the detritus of the Asian crisis. What is also emerging is that – coincident with China's emergence – Thailand has developed a competitive advantage in the production of autos, auto parts and certain types of consumer electrical appliances. These new areas of competitive advantage have attracted substantial amounts of FDI. Interestingly, there have also been a few instances of production previously relocated to China being brought back to Thailand – one example is the hard disk drive sector. Against these positives, there has however been one recent negative development. Hints that the policymakers would like to pursue a new economic model less reliant on foreign investors and on external demand have raised concerns among foreign investors. However, while this bears watching, reality has so far not matched rhetoric. For instance, legislators hastily retracted a draft bill to restrict the activities of foreign-owned hypermarkets as soon as signs of foreign investor concerns emerged.

Singapore's share of Asian-bound FDI has fallen – not surprisingly, given its near-developed status and the changing nature of its economy. Two changes in particular stand out: first, its economy is moving away from manufacturing to higher value services – following the pattern of most maturing economies; second, given its higher cost base, many producers of lower value-added activities are no longer profitable in Singapore and need to shift some activities to cheaper locations – just as we are seeing happen in Japan and Taiwan. Nevertheless, inward investment in key areas targeted by the government has surged in 1998-2001 as investments in pharmaceutical, process chemicals and high-end electronics plants were drawn in. In other words, Singapore may be receiving a falling share of FDI in Asia but it is receiving sufficient FDI in the context of what it needs in order to achieve good growth at its stage of development.

Malaysia. A number of factors can probably explain the fall in Malaysia's share of FDI in Asia: first, discussions with Japanese and other countries' multinational corporations suggest that the fall is partly due to uncertainty over its overall policy regime. Much of this is due to Malaysia's capital controls and its pegged exchange rate. The manner in which capital controls were imposed in September 1998 made foreign investors concerned about the sustainability of the capital controls regime. In addition, there is now considerable concern over the longer term viability of pegged currencies following the bad experience in Argentina recently. Second, the emergence of lower-cost competitors

Some countries such as South Korea, Taiwan, and Thailand have seen their shares of FDI grow



Other countries such as Singapore and Malaysia see their share of FDI fall, but this could be due to reasons other than China

such as China, Vietnam and Bangladesh has hurt Malaysia – its costs are higher than those in other Southeast Asian countries such as Thailand and it has not moved sufficiently up the value-added ladder as Singapore did. Neither has it developed enough new areas of competitive advantage, as Thailand did, in order to remain relevant. There are now indications that Japanese producers in Malaysia are about to shift significant amounts of production out of Malaysia – to China as well as other lower-cost economies such as Thailand.

Indonesia. Although the administration of President Megawati has made substantial progress in restoring rational policymaking and in stabilising the economy, Indonesia has been hurt by several substantially negative developments which point to continued significant disinvestment by foreigners. First, the tragic bombing in Bali has exposed and emphasised to foreigners the high political risks of operating in Indonesia. The continued threats against foreign interests, the existence of armed extremist groups and the weakness of the state security and intelligence apparatus are not likely to be overcome in the short run; second, the unusual judgements passed by Indonesian courts in cases involving foreign interests have also shocked foreign investors. For instance, Manulife of Canada saw its profitable subsidiary in Indonesia being declared bankrupt. Until it is clear that the judiciary can be relied upon to protect the legitimate interests of foreign investors, it is unlikely that FDI will recover.

In sum, plans by foreign investors to increase or relocate production in China have received much attention. But what is less appreciated is the broader impact of such decisions. An example is the recently announced plans by Honda to build a car plant in China, with the output exclusively for export to the EU and Asia. But, at the same time, Honda also announced that it would build a new car plant in Taiwan, a transmission plant in Indonesia, while also expanding its plant in the Philippines. One reason for investing in China is the removal (under WTO rules) of the requirement on China-based producers to source 40% of components from local suppliers. This means that Honda is able to source from existing plants in Thailand and Malaysia.

Honda's plans are not unusual. They tell us that the large global manufacturers: a) are building a production grid in Asia, where capital is rarely all allocated to one country (because different countries have various comparative advantages, these large producers choose different production bases to exploit the advantages); b) will not want to place too many of their factories in a single country – for simple risk-management reasons.

B. Exports: changing market shares reflect economic restructuring

The accompanying tables provide some analysis of China's export market share compared with that of other major Asian trading nations. A number of observations emerge:

- Through the course of the 1990s, *both* China *and* other major Asian trading nations increased their share of global exports – despite the tremendous damage done to these other Asian economies as a result of the 1997-98 financial crisis.
- The major loser was Japan. Most Asian exporting nations managed to raise their share of exports as Japan's fell. In other words, structural changes in the Japanese economy – the shift away from

Fall of FDI in Indonesia has been caused by many factors, unrelated to China

Global manufacturers are building a production grid in Asia

China's rising share of export markets

Percentage share of world exports	1990	2000
China	1.8	4.0
ASEAN	4.3	6.9
6 East Asians ¹⁾	7.9	10.5

¹⁾ Korea, Taiwan, Hong Kong, Singapore, Malaysia and Thailand

Source: World Trade Organization (website)

manufacturing to services and the push among Japanese producers to diversify production locations in order to cut costs – are important in understanding China’s impact.

- Taiwan’s share also fell, marginally. This has much to do with Taiwanese companies’ deliberate strategy of shifting production to China and Southeast Asian economies – in an effort to cut costs and improve profitability, mimicking what Hong Kong producers did in the 1980s.

Asian exports: China’s share of total rose – as did others’ shares

	Exports USD bn 2000	Share of total Asian exports, %	
		1990	2000
Asia	1649.2	100.0	100.0
"Winners"			
China	249.3	8.4	15.1
Hong Kong	202.4	-	-
(a) domestic exports	23.7	3.9	1.4
(b) re-exports	178.8	-	-
South Korea	172.3	8.8	10.4
Singapore	137.9	7.1	8.4
(a) domestic exports	78.9	4.7	4.8
(b) re-exports	59.1	2.4	3.6
Malaysia	98.2	4.0	6.0
Thailand	69.1	3.1	4.2
Indonesia	62.1	3.5	3.8
India	42.3	2.4	2.6
Philippines	39.8	1.1	2.4
Vietnam	14.5	0.3	0.9
"Losers"			
Japan	479.2	38.9	29.1
Taiwan	148.3	9.1	9.0
Australia	63.9	5.4	3.9
New Zealand	13.3	1.3	0.8
Pakistan	9.2	0.8	0.6

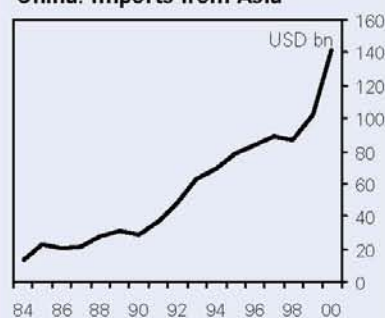
Source: World Trade Organization

C. China’s positive impact on the rest of Asia

The accompanying charts make clear the following points about the positive impact of China on the rest of Asia:

- Chinese imports from Asia are rising, in some cases quite strongly.
- Chinese tourist arrivals in the rest of Asia are also growing. In particular, the rates of growth for Malaysia are almost explosive.
- China is also emerging as a major investor in other parts of Asia. Disaggregated data on China’s investment abroad is scarce but the accompanying chart shows that the Chinese are investing abroad at an accelerating pace. Media reports have shown that a good part of this is coming to Asia, e.g. purchases of resource industries in Indonesia.

China: Imports from Asia



Source: Collated from CEIC

These developments reflect structural changes in China which are likely to remain positive drivers of rising Chinese demand for goods and services from other Asian countries:

- Rising incomes, including the rapid emergence of a high-spending middle class, results in higher demand for imports. Asian producers who are sensitive – from their own experience – to the special needs of an emerging middle class (price sensitive but still quality conscious) can benefit.
- A much more open economy. The WTO process is only one part of the opening of China to imports. China has also offered free trade agreements (FTA) with other Asian countries. It has already struck agreement with the 10 members of the Association of Southeast Asian Nations (ASEAN) to form an FTA and has offered a substantial "early harvest" of Chinese concessions on import barriers to ASEAN. The Chinese government has also reduced many restrictions on Chinese investment abroad as well as restrictions on the ability of ordinary Chinese citizens to travel abroad.

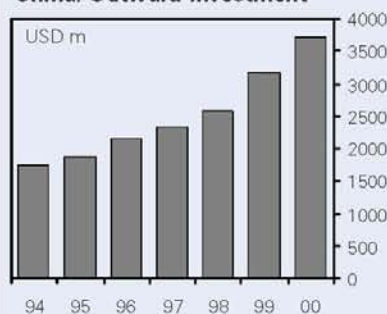
The question arises, whether WTO accession will boost China's share of exports and FDI even more. There are several forces at work, and the net effect is likely to be that China's increased share of FDI and exports will reach a peak.

On the one hand, China has two positives going for it – the WTO and Japanese restructuring. China will gain much from its accession to the World Trade Organization (WTO): its exporters face reduced trade barriers, while FDI is drawn into China by the promise of a large market now open to foreign goods and services. In addition, Japanese companies initially wary of investing in China now face such intense competitive pressures that they can no longer avoid China. Corporate Japan is beginning a huge adjustment, pushing substantially greater FDI to China rather than previous favourites such as Southeast Asia. In addition, Japanese producers are also re-locating production from Japan and Southeast Asia to China.

On the other hand, however, we believe that any further gains in China's share of global FDI and exports will be limited. China's gains are best understood in terms of a portfolio approach. Global producers are re-balancing their portfolio of investments and production bases to take account of positive but one-off developments (see below), but such processes have a finite duration. Once an optimal portfolio distribution is reached, further gains in China's share will cease, perhaps even reverse. These one-off developments are:

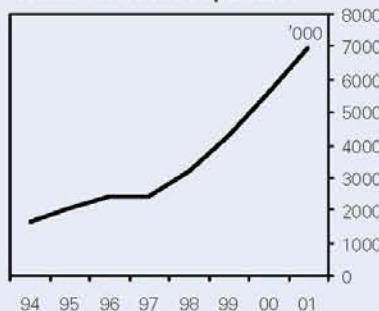
- More open policies towards foreign investment. When previously closed economies open up to FDI, global producers will tend to adjust by increasing their presence in such locations. This is why FDI in both China and Korea has increased. During this period of "portfolio re-balancing", the share of previously-closed economies in global FDI will rise at the expense of those who opened up earlier. Since many Southeast Asian economies were early in wooing FDI, they will inevitably see a decline in their share.
- Restructuring of economies, especially Japan, Hong Kong, Taiwan and Singapore. The manufacturing share in GDP in these economies is falling. For Hong Kong, the shift is out of low-value services to

China: Outward investment



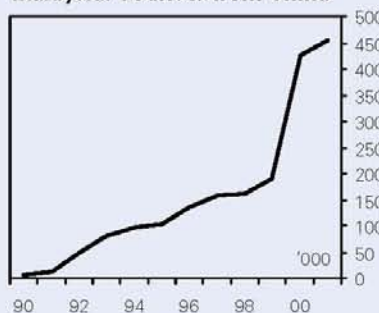
Source: Collated from CEIC

China: Resident departures



Source: Collated from CEIC

Malaysia: Tourists from China



Source: Collated from CEIC

more remunerative services. China is opening up just in time to cash in on these economies' need to shift some parts of their value chain abroad.

- Improving returns in reforming countries. The relative returns that each economy can offer investors is critical in determining FDI flows, explaining for instance why China and Korea have done so well in FDI terms. Reforms in both China and Korea have released supply-side efficiency gains which substantially increased the returns from investing in these economies, thereby making these economies much more attractive to investors.
- Competitive advantage. There are limits to how much China's competitiveness can rise. First, global corporations are finding China wanting in several areas – legal structures, intellectual property rights protection, logistics, availability of technology and appropriate suppliers, etc. These will take time to resolve. Second, high growth is raising Chinese costs in locations favoured by foreign investors. The argument that labour costs will not rise because China's under-employed rural masses form an unlimited supply of labour is questionable. Labour mobility has its limits and there are political reasons why China's leaders will probably not allow a flood of rural workers into the main urban conurbations. Thus, labour – and other – costs will probably rise as economic growth continues.

Moreover, China cannot be cost-competitive in every single mass-manufacturing segment as some argue. No country can allocate resources to every activity in which it has an absolute cost advantage without putting so much pressure on resources that costs would rise, eliminating the initial cost advantage. Thus, there is a limit to the new industrial sectors incremental FDI can flow into.

This being the case, we would argue that there is a finite limit to China's increased market share in FDI and exports.

The portfolio re-balancing referred to above has a finite duration. Once a new optimal portfolio allocation is achieved, the additional FDI flows needed to correct the earlier under-investment in China will not be necessary. In this new equilibrium, each economy receives a share of global FDI that reflects economic fundamentals.

Similarly, reforms produce one-off efficiency gains which boost returns. There are few studies of such efficiency gains in China available that quantify the incremental stimulus to returns we can expect in coming years. But since a large part of the reforms has already been in place for some years, it is reasonable to say that China has progressed through a good part of this one-off gain.

China has so far enjoyed the benefits of reforms and restructuring while containing the ill effects. Our suspicion is that the more painful reforms to tackle long-deferred problems such as the unequal distribution in rural areas, non-performing loans at the state banks and the under-funding of social security plans will now lead to stresses and strains in the economy. As these become more apparent, China's relative attractiveness as a destination for FDI will also be adjusted down.

Finally, Asian economies are already reacting to the growing competitiveness of China. Their responses – if effective – are likely to improve their relative attractiveness to FDI as well as their export competitiveness. This too would produce a reversal in the increase in China's market share.

China cannot be cost-competitive in every mass-manufacturing segment

There is a finite limit to China's gain of market share in FDI and exports

More painful reforms on long-deferred problems will lead to stress and strains

Regional responses to China's emergence

The question, then, is how the Asian region is responding and how effectively it can adjust to China's emergence.

A. Policy responses have been largely positive

Three sets of countries can be discerned in terms of the quality of their policy responses:

- The relatively better-governed crisis-hit countries of Korea, Thailand and Malaysia have moved beyond crisis management to longer-term policy measures targeted at strengthening competitiveness and sustainability.
- Countries less affected by the crisis are also responding with increasing resolve. Whether they are poor countries (e.g. India and Vietnam) or more advanced ones (e.g. Singapore and Taiwan), substantial policy adjustments are underway.
- A third group of countries is saddled with a heavy burden of political dislocation and structural weaknesses, such that their ability to adjust quickly is impaired. This includes Indonesia, the Philippines and Pakistan.

It is worth emphasising that Asian policy reforms pre-dated the crisis. Many countries (e.g. Singapore, the Philippines) initiated major reforms well before the crisis – privatisation, deregulation of restrictions on private or foreign businesses, removal of irrational pricing policies, etc. Such moves reflected the need to respond to growing competition – from China as well as others. As these pressures have intensified, policy responses have taken on greater urgency.

The cases of India, Vietnam and Singapore help illustrate how Asian countries have responded to China's emergence.

India. The coalition government led by the National Democratic Alliance (NDA) comprises 26 parties and came to power on the back of some anti-foreign rhetoric. Yet this same government has moved faster than expected on privatisation, liberalisation of restrictions on foreign ownership of key sectors and infrastructure construction. One reason is that Chinese competition exposed weaknesses in India's policy regime and infrastructure so starkly that the pressures for change have become irresistible. For example, many Indian manufacturers sell leather to Chinese shoemakers rather than make shoes themselves because Indian regulations stipulate that only small establishments can make shoes. The result – no Indian footwear producer can grow enough to enjoy the economies of scale required to be globally competitive. India's bad roads and ports also make its exporters less competitive in aspects such as timely deliveries to international clients, while inadequate electric power forces companies to have their own generators, thus raising costs¹.

India's policymakers are now being pressed to address policy failures such as these. The government has started the most ambitious road building programme in several decades. It has also started to reform laws which restrict large companies from manufacturing certain items. And it has kick-started the privatisation programme, selling controlling stakes in hotels, telecommunications companies and petroleum-related

Quality of policy responses to China's emergence has varied from country to country, but has been generally positive

India has strived to move faster on privatisation and liberalisation

¹ Software producers in Bangalore suffer a 10% increase in energy costs from this factor alone.

industries to private buyers. Efficiency gains are already visible as a result, suggesting that returns on investment in India are likely to improve significantly².

Vietnam is another example of a country which long resisted liberalising at a rapid pace. In the past two years, it has begun to move more aggressively in areas such as limits on foreign ownership, the room given to private entrepreneurs, and privatisation. Part of the reason for the change in policies is almost certainly related to well-publicised cases of Chinese imports swamping domestic production – e.g. in the motor-cycle sector.

Vietnam also has begun to accelerate reform

Singapore. At the other end of the policy spectrum, we find economies such as Singapore, which were already very open to foreign investors, undertaking further policy changes in order to make themselves even more attractive to FDI. First, corporate tax rates are planned to be cut significantly – from an already low 24% to 22% in 2003 and to a target of 20% soon thereafter. Second, the financial sector has been opened up to foreign investment, as has telecommunications – resulting in the entry of more foreign businesses to Singapore.

Many countries are realising that they need to cooperate better in order to compete more effectively. Hence, the proliferation of efforts to work out new **trade agreements**:

- Many countries are pursuing bilateral free trade agreements with large economies. Singapore leads in this respect, having concluded agreements with New Zealand and Japan. It has also completed negotiations with Australia successfully and has cleared virtually all difficult issues with the US suggesting that FTAs with Australia and the US will be signed within the coming months. Singapore has also initiated a study group with India on an FTA. As a result of Singapore's success, others are now keen as well – Thailand and the Philippines have initiated FTA discussions with Japan.
- Other countries are attempting to integrate their economies more closely with China, either through formal free trade agreements (e.g. Hong Kong) or by relaxing restrictions on economic links with China (e.g. Taiwan).
- There are also multilateral trade talks to achieve greater economic integration in Asia. China is aggressively pursuing a free trade agreement with ASEAN and there has already been considerable progress in this area. At the November ASEAN summit meeting with China, both sides agreed to achieve an FTA within 10 years. They also agreed to phase in several reductions in import restrictions as an "early harvest" – with China offering to make substantial concessions ahead of ASEAN. Japan has countered with an offer to ASEAN for a comprehensive economic partnership which it hopes will eventually be extended to other parts of Asia. The US has responded with its Enterprise for Asia Initiative under which it has indicated it would favourably consider FTAs with Asian countries. India too is discussing with ASEAN how their economies can be further integrated.

ASEAN countries are forming a Free Trade Area with China

² The completion of parts of the new national highway system has already led to substantial cost savings in the Mumbai-Pune region – where travel time between the 2 key industrial cities has been cut by about 2 hours.

On the one hand, regional trade agreements have been slow-moving due to a lack of political will to make the necessary sacrifices of national interest. This is one reason why the ASEAN Free Trade Area has been slow to take off for instance. On the other hand, despite this, even the little progress made quite often produced material economic benefits.

The lowering of tariffs has helped ASEAN-based producers lower costs by sourcing components from lowest-cost locations. As a result of this improved cost efficiency, there is anecdotal evidence to suggest that, say in motor-cycle assembly, ASEAN-based producers have succeeded in mitigating the adverse effect of a surge in Chinese exports. Lower barriers to intra-ASEAN trade have also enabled producers of consumer goods to consolidate production in 1 or 2 locations and thereby enjoy economies of scale they could not enjoy before.

Finally, except for China, Malaysia and Hong Kong, Asian policymakers have given up fixed exchange rates. The bias in currency policy in most economies is clearly towards maintaining competitive currencies unlike the pre-crisis exchange rate regimes. This gives these economies an additional degree of freedom in responding to China.

B. Corporate restructuring by domestic companies boosts competitiveness

Asian companies still have a long way to go to achieve maximum efficiency. However, putting together the evidence of how the more successful ones have been changing, we obtain the pattern of response – which in the future should accelerate.

1. Innovation and application of technology. For economies such as Korea, Taiwan and Singapore, the restructuring has to focus on moving up the value-added ladder. This is happening. Take Taiwan as an example. The migration of Taiwanese semiconductor firms to 12" wafers is expected to materialise in two years' time. Taiwan's overall cost advantage will grow as a result, since 12" wafer technology cuts costs by 30%. Moreover, Taiwan's pace of patent creation is increasing. As mentioned earlier, it moved from 11th rank worldwide in the number of patents in 1990 to 4th in 2000 (Source: US Patents & Trademarks Office). Taiwan used to get patents for improving production processes. Now it gets the bulk of its patents for product innovations.

With such innovation capacity, Taiwan has been able to develop new growth areas to replace segments lost to China. For example, Taiwan's chip designers are making strong headway in chips used in DVDs, telecommunications, computer displays, and consumer products such as interactive toys. Taiwan now ranks second in the world after the US in terms of chip design revenues and has 200 fabless design houses.

2. Cost cutting through better work methods. There is substantial effort under way to cut production costs through improved production processes and through improved procurement and outsourcing.

3. Exploiting the Chinese market. Sampo and Haier, the two biggest consumer appliance makers in Taiwan and China, respectively, agreed to make and sell each others' refrigerators, telecommunications equipment and computer peripherals in their respective home markets as well as globally. Indian companies are developing strategies to exploit the Chinese market. For example, Reddys, a

At the micro level, domestic companies are moving on restructuring

The NIEs have to move up the value-added chain ...

... and sell to the China market

pharmaceutical company, has a base in Shanghai to develop drugs for the Chinese market. India's IT training giant, NIIT, has 42 centres in China, with plans to increase them to 500 by 2005.

4. **Development of new models for consumer goods.** For instance, Southeast Asian assemblers of motor-cycles are reported to have developed new, lower cost models that compete better against Chinese exports.
5. **Sectoral restructuring.** For instance, Thai steel and cement producers have merged, achieving greater economies of scale. There has been substantial consolidation in regional banking too.

The bottom line: the rest of Asia is not passive in the face of the competitiveness shock posed by China and other new competitors. Adjustment processes are underway, creating a new equilibrium. This new equilibrium will allow countries which get their basics right to find their own niche and prosper. Other countries – or companies – which fail to make the right changes will, however, be penalised heavily. There will thus be a much starker distribution of winners and losers as a result.

Bottom line: Asia is not passive in the face of China's emergence

Strategic implications of China's rise for the rest of Asia

It would be surprising if the rapid economic growth of a large country with a deep sense of its own historic greatness did not produce tremendous political and security consequences for its neighbours. This section attempts to provide a characterisation of the geo-strategic forces set in motion and assesses the direction in which this might take Asia.

A. What do the longer-term trends point to?

All long-term projections are clearly educated guesses but such projections are nevertheless useful in setting important trends in perspective. We use projections by the Rand Corporation in "Asian Economic Trends and Their Security Implications" by Charles Wolf Jr as the best available study. Some interesting conclusions emerge:

First, China's relatively more rapid growth compared with other countries will mean that its relative economic weight in the region will rise. However, the study shown in the table overleaf makes an assumption that other countries (especially India) are expected to also grow rapidly, therefore, China's relative weight does not rise as much as many today appear to expect. Note, however, that many commentators would question whether the Rand study is on the right track in projecting India's average growth rate to be so significantly higher than China's in the decade to come. Quibbles about long-term projections aside, the basic point remains – China's weight in the region will rise but since it is reasonable to assume that other countries' growth rates will catch up with China as China inevitably slows, its weight may not rise as much as the simple extrapolation of today's trends might suggest.

China's economic weight in the region will rise further

Second, the projections suggest that China's economic growth will be able to fund a massive expansion of its military spending – this is seen rising from around USD 90 bn in 1995 (PPP terms in 1998 dollars) to USD 171 - 250 bn by 2015. This would eclipse the growth in military spending by other major Asian countries except India – which is seen by the Rand study as keeping pace with China's military expansion.

Economic growth could help fund military spending

China's economic weight rises only moderately in comparison with others

GDP (USD tr) ¹⁾	1995	2000	2005	2010	2015	Growth % p.a.
Japan	2.9	2.9	3.1	3.4	3.6	1.4
China						
a. Stable scenario	4.5	6.0	7.6	9.6	12.4	5.0
b. Disrupted scenario	4.5	5.7	6.8	7.7	8.5	2.7
India	2.2	3.0	4.0	5.2	6.7	5.8 ²⁾
Korea	0.7	0.7	0.9	1.2	1.7	5.6
Indonesia	0.7	0.7	0.9	1.1	1.4	4.2
China's GDP relative to other big Asians' combined						
a. Stable scenario	40.9%				48.1%	
b. Disrupted scenario	40.9%				38.8%	
China's GDP relative to India's (times)						
a. Stable scenario	2.0				1.85	
b. Disrupted scenario	2.0				1.27	

¹⁾ GDP in purchasing-power-parity terms in 1998 US dollars

²⁾ Rand projection for India's higher growth relative to China might not be accepted by many analysts.

Source: Asian Economic Trends and Their Security Implications, Charles Wolf Jr, 2000

Whatever the actual outcome, it is clear that China will be much more powerful in relation to Japan and other Asian countries. This is bound to have an impact on China's behaviour and that of its neighbours.

B. China's own strategy and goals are probably limited – for now

As the above section argues, China's weight of influence relative to Japan and others will certainly rise in Asia. It is important therefore to understand what drives China's strategic thinking on its role in Asia. Judging by its actions and statements, China's regional policies are probably informed by the following objectives:

1. To secure itself from what are likely to be the main threats it could face in the region. These are, first, a US which is a hyper-power and which is determined to maintain a strong position in Asia including in areas sensitive to US concerns such as Taiwan. Second, a potentially re-armed Japan, and third, irredentist claims on its western territories (Xinjiang's population comprises mainly Uighurs and other Muslim Central Asians, for instance³⁾).
2. To ensure that its interests can be protected in disputed areas such as the Spratly Islands.
3. To ensure sufficient access to supplies of energy and important raw materials.
4. To possess sufficient military power to deter Taiwan from declaring independence. It would want to increase its military advantage over Taiwan progressively so that its bargaining clout with Taiwan keeps rising.
5. To contain any damage from potential crises in the Korean peninsula and Central Asia.

China's regional policies will factor in the role of the US, Japan and irredentist claims on Chinese territories

³⁾ See the previous article in DBR's China series "The domestic political challenge", September 27, 2002.

6. In the longer term, to ensure a status for China as pre-eminent force in East Asia, not in the sense that it seeks domination but in terms of being able to take the initiative in key issues and win for itself substantial room for manoeuvre.

Thus, China's political-security moves will probably be marked by a benign and pragmatic approach. In the coming 5-10 years, China realises that it cannot risk the economic growth so vital to ensuring the current leadership's grip on power by entering into foreign adventures or by alienating the US. The pragmatic Chinese leadership fully appreciates the overwhelming military and political power of the US and prefers to avoid confrontation with the US for quite some time to come. Thus, China's interaction with the rest of Asia will be characterised by the following:

- It is not likely to provoke a security crisis in Asia. There is only a small risk that China would turn aggressive. This would be if say, there were a major political crisis in China in which a less pragmatic leadership sought a military diversion from domestic political travails.
- But it will probably invest substantial energies and resources in building its military capacity, initially focusing on being able to pull off a quick victory in any war with Taiwan. It will probably seek to ensure sufficient capacity to project power effectively in its immediate area of strategic interest, i.e. Southeast Asia as well as Central Asia.
- It will increasingly focus on protecting its strategic economic interests. Hence the forays into purchases of coal and other energy resources in Indonesia, for instance.
- It will continue building influence in neighbouring or nearby countries such as Vietnam, Myanmar, Thailand and North Korea where it has a good relationship with ruling elites. This will be done in the hope that such countries will become allies, helping China to project influence in important regional groupings such as ASEAN.
- It will downplay territorial disputes with other countries and avoid a military confrontation with Taiwan as long as possible. China's recent agreement with ASEAN on a code of conduct in the disputed Spratly Islands is an example.
- It will focus on weaving together a set of formal relationships which will be designed to bring key regions (especially Southeast Asia and Central Asia) increasingly closer to China. Hence its aggressive pushing of ASEAN to work out a China-ASEAN free trade area. Hence too its (not-too-successful) attempt to create the Shanghai Five grouping to tackle issues in Central Asia.

However, beyond this period, if China's rapid growth continues there is a possibility that it may become more assertive, using its economic and political weight to press its neighbours to increasingly acknowledge its authority. Whether this risk materialises will depend on (a) the Chinese ruling elite's own political interests; and (b) how robustly other big powers such as the US, Japan and India react to China's strategic moves in the region.

China will likely take a benign and pragmatic approach

It will not likely provoke a security crisis

China could potentially use its clout more assertively, depending on China's own ruling class and responses from other big powers

Conclusion

In sum, China's rapid growth as an economic and political power will likely:

- 1. Change the economic division of labour in Asia.** But there is no inherent reason why other Asian countries must lose out to China – only countries which are unable to adjust effectively will lose. Others will gain.
- 2. Create a new geo-strategic balance in Asia** in which Japan and the US will seek diplomatic means to limit China's efforts to project itself and make strategic gains. As India and Korea grow, they too will begin to participate in this game but it is too early to say whether they will ally with the US/Japan (as their current strategic needs indicate) or whether they will seek to play each major power against the other.

China's rise will change division of labour and geo-strategic balance in Asia

Manu Bhaskaran, Singapore, +65 9636 1056