

Investing in China – Risks and Opportunities
An assessment of recent political and socio-economic trends

This speech focuses on the following topics:

1. The need to know where we are coming from
2. The current issues and challenges
3. The prospects

1. The need to know where we are coming from

Before an assessment of the current trends and of possible scenarios in the future can be made it is important to look back into China's distant and not so distant past. There is first of all the burden of history, which has shaped both the perceptions the West has about China and the perceptions the Chinese have about the West.

Many Westerners react surprised, when they are told that in the 18th century two Asian countries, India and China accounted for about half of the world's GDP. Up till very recently, the picture the West has had of India and China has been shaped by the idea of Oriental decadence. Indeed, both these great cultures had descended into decadence for around two centuries. In China's case the misfortune in the 19th century and in the first half of the 20th century had been self-inflicted as well as caused by external powers.

Unforgotten up to this day is the humiliation China experienced during the two opium wars in the 19th century and the insult to the Chinese people that had resulted from the decision of the Versailles Peace Conference to transfer the German possessions in China to the Japanese. These events as well as other encounters where the Chinese were losing out to foreigners, helped create a "wounded civilisation" with scars that can easily emerge in chauvinistic and xenophobic reactions. This difficult past not least plays a role in the very difficult and sometimes rocky relations between China and the United States of America.

The second historic legacy weighing heavily on modern China is the rule of Mao Zedong. Mao as the founder of the People's Republic and the man who brought peace to a country that had been ripped apart by a particularly bloody civil war, had – at the start – undisputable historic legitimacy for his rule. However, he left a legacy drenched in the blood of his own countrymen. Both the disasters of the "Great Leap Forward" and of the catastrophe of the "Great Cultural Revolution" come to mind. It will take a long time and considerable political acumen for the country to finally come to terms with a proper assessment of Mao and to emancipate itself from its founder, who more than a Marxist Leninist was a Legalist in the classical Chinese mould of the third century B.C.

The third crucial development to understand where modern China has come from, are indeed the economic reforms and their impact. The reforms had been started by Deng Xiaoping immediately after the death of Mao. The balance after thirty years is both impressive and deficient: Concerning the economic development of the country the Chinese leadership can claim full marks.

When it comes to social progress the record is mixed. In urban areas – and not only in the big cities like Shanghai, Guangzhou and Beijing – progress has been phenomenal. Today's China cannot be compared to the China of ten years ago, forget about the China that Mao had left behind.

In terms of political evolution the record is bleak indeed. While the country has undergone unprecedented change in the economic and social fields, the terms under which it is governed have remained the same. The Communist Party of China, which was and continues to be the sole source of power in the People's Republic, still remains above the law as had been the case under Mao Zedong.

It is important to recall that the reforms undertaken by Deng and others were not only of economic significance but that they had a great impact on the country's position within and towards the world. Under Mao China had closed itself off from the world, today it is a full part of the world community and of the world economy. When Deng started the economic reforms he knew that the modernisation of China was only possible if the country opened itself to the outside world. China needed foreign capital and foreign technology to launch its industrial development and it needed foreign markets to sell the produce, as the purchasing power on the domestic markets was totally inadequate. Today, the world faces a China, which never has had so many of its people with knowledge of or experience in the outside world. This is indeed a tremendous asset.

2. The current issues and challenges

During 2002/2003 China changed, according to official parlance, from the third to the fourth generation leadership. Party Leader and President of the Republic Jiang Zemin handed over the reigns to Hu Jintao and Wen Jiabao succeeded Zhu Rongji as Prime Minister. This was the first orderly transfer of power in the history of the People's Republic. Both Hu Jintao and Wen Jiabao are men in their early sixties who have a good educational background and an excellent record as technocrats. They face a number of challenges that are unprecedented in the short history of the People's Republic, namely the change in pace and emphasis of economic growth; the legitimacy of the existing system; the reform of the financial sector.

Since a few years the leadership has coined "sustainable growth" as the main principle of its socio-economic policies. In the nineties the goal had been as much growth as possible. However in the early 21st century this course of action had begun to show some serious deficiencies. The main problems China faces at the beginning of a new century are: a rapidly growing wealth gap both between different regions of the huge country and between different parts of its population; a rapidly deteriorating natural environment; a very inadequate usage of scarce raw materials and energy sources; bottle necks in the infrastructure.

The first question is, why a far-reaching change in growth patterns is required; the second question is whether such a change in emphasis and priorities can be achieved.

First of all, a change in the emphasis of growth is necessary because of the danger that in several areas speculative bubbles have been built up and that the bursting of these bubbles could lead to social destabilisation. Secondly, in a number of fields there is overinvestment and excessive capacity, which leads to the squandering of valuable resources. Thirdly, the fact that China, a country that is still governed by a system that claims to adhere to Socialism, is now at the top of the rankings in social inequality (Gini Coefficient) is a warning sign that a further acceleration of the wealth disparities will threaten social peace and political stability. Finally, the exploitation of China's natural environment has reached proportions that are not sustainable. Particularly with regards to water supply large parts of China are in for dramatic times.

There can be no doubt that the enlightened elements in the Chinese leadership recognise these challenges. The question remains whether they can be implemented. There are strong indications that particularly in the successful, richer regions and cities there is resistance against a policy of self-restraint. There have always been wrong perceptions about how far Beijing's writ runs in this huge country and how efficient it is. Furthermore, it would be wrong to consider the Chinese leadership and the Chinese administrative elites as a monolith. There are profoundly different opinions about the direction the economic development of the country should take. While, like in every country and in every political movement, the largest segment belongs to those who opportunistically follow the way the winds blow, there are apart from the modernizers and those who advocate the opening up and the liberalisation of China's economy and society, those who favour a more cautious course or who even dream of a return to the more egalitarian policies of the past. The influence of each strand of opinion depends of course on the success of the current developments. In this it is important to bear in mind that in China political stability and the undisputed rule of the CPC is still the central goal, far more important than any economic consideration.

A far more serious challenge facing the fourth generation leadership concerns the legitimacy of the existing one-party-rule. Around the world dictatorships, too, search for legitimacy, a legitimacy, which by their very nature they cannot win at the ballot box. History can be used as a tool for legitimacy. Without any doubt, Mao Zedong as the founder of the People's Republic of China had legitimacy. Deng Xiaoping, the great reformer and modernizer (and a former participant of the "Long March") had historic legitimacy. This basis, however, became already much weaker under the leadership of Jiang Zemin, who was a young man at the time of the revolution. Jiang tried to gain legitimacy as an international statesman, an endeavour in which he received the support of US President Clinton.

Today's leadership, however, has no historic legitimacy. Hu and Wen were young children, when the civil war ended. Furthermore, with the opening of China and with the pragmatism which has been the hallmark of the economic and social modernisation process, the ideological purity and credibility of the CPC has been strongly diluted. On the other hand there is a strong need to find new values. This means that continually high economic growth is the sole strong basis of legitimacy the present leadership has.

China has a long history of social unrest and even revolutions. In the traditional Chinese value system this is expressed by the concept of the "Mandate of Heaven". Under this concept, which is very Confucian in nature, both the citizens and the emperor have duties to fulfil. The citizens have the duty to be the loyal subjects of the authorities, while the emperor has the duty to make sure that the borders are safe, that there is law and order prevail in the country, that the public infrastructure is well maintained and that the people are prosperous. If he fails in these duties it is the right, even the duty of the people to overthrow the regime.

Even according to statistics published by the authorities there is considerable social unrest in the country. This has to do with the difficult process of modernisation but also with two developments that to the authorities are major reasons of concern: the growing wealth gap and corruption. China has long passed the stage, where the major source of social and political discontent were dissidents, human rights campaigners or the Falun Gong movement. Today, the discontent is far more wide-spread and it has reached segments of the general population. Clashes with the authorities occur with dissatisfied farmers that have been deprived or cheated of their land, dissatisfied workers who have lost their jobs or who have not been paid their salaries, dissatisfied pensioners etc. etc.

Even the leadership admits that corruption is the one issue, which might bring down the rule of the Communist Party. The Chinese are in general very generous of other people owning or earning more. To get rich is, so the saying of Deng Xiaoping, glorious, it is also a perfectly justified aspiration. However, admiration for wealthy people turns into anger when there is the feeling that this wealth has been gained through corruption. There is no doubt that particularly amongst the urban population there is growing unease about corruption in the country and that the opinion that cadres in the party and administrators are corrupt is widespread. This is a very precarious state of affair and it is not helped by the fact that as long as there is no rule of law in the country and as long as the party stands above the law there is no possibility to get to grips with the problem. The occasional condemnation of single corrupt individuals does nothing to solve the problem in general. Furthermore, the lack of safety valves in the political system of China ensures that personal anger and discontent quickly turn against the authority, which, taking into account the traditional rebelliousness of the Chinese, is not a very satisfying situation and promises some trouble for the future. By the way, the endemic problem of violations of intellectual property rights is one of the consequences of widespread corruption and the lack of the rule of law.

One of the major challenges for the modernisation of China's economy and China's society is the reform of the financial sector. For a long time progress had been extremely slow. Recently, not least because of the commitments China had undertaken when it joined the WTO, the process of gradual reforms has gained speed and depth.

First of all there has to be taken into account a structural problem that weighs heavily on China's financial sector – the all pervasive power of the apparatus of the Communist Party of China. Obviously, finances are a key to maintaining the absolute power the CPC has been exercising since the founding of the People's Republic. It is equally obvious, that nobody who holds the power the CPC holds, is giving it up without a fight. Bearing in mind that the central goal of all economic policies in China is and will continue

to be the securing of the absolute power of the CPC, reforms in the financial sector have to be strictly limited. Statistics show that the major state banks have been extremely biased in their credit policies to support state enterprises even if these were of little or no economic viability. The support given was obviously made under political considerations.

There are a number of bright spots in the current situation: This year China has become the world's biggest holder of foreign currency reserves. China will soon become the first country to hold foreign reserves that exceed USD 1000 billion. Without any doubt this is not only beneficial and there are a number of challenges that await China in the field of currency regimes. Nevertheless, such a cushion is of vital importance both for further reforms in the financial sector and for the government's ability to deal with economic emergencies. The problem of bad loans: There has been progress in the recent past, however, there are danger signs on the horizon, namely the problems of exuberance on the real estate markets and the problems caused by the creation of excess capacities in certain industrial sectors.

Concerning the external value of the Yuan Renminbi the situation is rather complex. It is almost certain that Beijing will not kowtow to any external pressure, especially if it comes from Washington. There can be no doubt that by traditional economic standards the Yuan is undervalued. When and how this situation will be corrected is a question nobody outside the Standing Committee of the Polit Bureau of the Central Committee of the Communist Party of China knows. Furthermore, it is questionable that a stronger revaluation of the Yuan than has been the case up till now will be a panacea for industries that in the Western industrialised countries face strong competition from China.

Finally, one of the brightest prospects in the Chinese financial sector concerns the insurance industry and within that particularly the life insurance sector. The social change that is happening and even accelerating within urban China has serious implications particularly for old age provisions. Ever more people have the need and the means to look after their own old age. The option of a life insurance, which in the past had been of marginal interest is becoming ever more attractive. In addition, as within the banking system, foreign participation provides the Chinese consumer with new choices and new security.

3. The prospects

The lessons of China's recent history are: Mao and the People's Republic were not the unavoidable destiny for the Middle Kingdom. Things, with a little bit of luck and some skilful leadership, could have taken a different course both in the 19th and in the 20th century. A lot of what happened to China during the last two centuries resulted in self-inflicted wounds. One of the main omissions was that the rich options of developing into a modern democracy that are available in China's splendid history had not been used or were wrongly deemed to belong to a "reactionary" past.

The main onus, which China is facing at the beginning of the 21st century, is that of being a Great Power, of being the pre-eminent power in Asia. This implies new responsibilities. On the other hand it is wrong to see China as a future global power like the United States. In fact a number of American thinks-tanks are already portraying China as the main future super power to challenge the United States. All this is wishful thinking. China will, for a very long time, not be able to challenge the US on a global level. There are mainly two reasons for this rather definitive statement. For those interested in the Chinese markets the giant population of 1.3 billion people exerts much fascination. However, the huge dimension of the Chinese population is not only an asset. First and foremost the population of 1.3 billion means that all the social and environmental problems China faces are of enormous dimensions. One only has to think that although some 260 million Chinese can today be counted as middle class, the huge majority of the population still lives in very modest conditions. Some 800 million Chinese still find their mostly meagre income in agriculture. More than half of them would not be needed if Chinese agriculture was to be as efficient as it is in the West. But where would the hundreds of millions of "surplus" people go?

The second reason why China is not going to be a global super power is that unlike the United States China has a very difficult and in many ways potentially hazardous neighbourhood. There is of course the dangerous crisis spot of North Korea, then there are the still problematic relations with Japan which Beijing sees as a nation that can quickly be mobilised. Then there is the thorny issue of Taiwan. Most of China's South East Asian neighbours are wary and suspicious of Beijing's designs in the South China Sea.

India has become a major rival in economic terms. Beijing and New Delhi often aspire for the same scarce raw materials and energy sources. After the collapse of the Soviet Union China was faced with new neighbours, the Central Asian republics. Here Beijing fears, not without reason, that militant islamists might use these feeble new states as their bases for destabilising China's far West. Finally, there is the huge border with Russia. Moscow looks with a certain concern at the economic rise of China and at the demographic shifts that are taking place in the Far East of its vast country.

An important consideration when looking at the future prospects of China must be the political stalemate that continues to plague the country. Obviously, the ruling Communist Party will do everything to stay in power. However, history shows that when a country undergoes profound socio-economic change, but remains stuck with obsolete political structures, sooner or later a rupture cannot be avoided. If the current economic development continues for the next five years the size of China's middle class population will reach some 400 million people. This would be a crucial moment when far reaching political change without the danger of a disruption through extremism or populism would be possible. Today, the leadership fears, not without reason, that a rapid introduction of democracy, of the principle of one man one vote, could lead to unrest. On the other hand, if the country remains stuck in the present political impasse, the necessary change will be all the more dramatic. Most important is that China moves quickly towards the rule of law. The peaceful political evolution in Taiwan points the way. Once the rule of law is established, once a significant part of the population is middle class and has something to lose, society is ready for democracy. That China stays stable and peaceful, that its political system evolves towards rule of law and democracy and that the people continue to enhance their material conditions – such a prospect is good not only for China but for the whole world.
