

DNI-PRIVATE SECTOR WORKSHOP ON POLITICAL AND ECONOMIC STABILITY IN CHINA¹

*Carnegie Endowment for International Peace
1779 Massachusetts Avenue, N.W.
Washington, D.C.*

January 24, 2007

SUMMARY

This conference brought together leading China experts in academia, the business community, and the US intelligence community to assess political, economic, and investment risk in China over the next two decades. Speakers agreed that China is in the midst of an economic transformation the scope of which has seldom been seen in modern world history. Significant and increasing demand exists for resources, including energy, to drive this transformation. Despite Chinese efforts to acquire new energy supplies abroad, dirty coal will continue to dominate energy usage. The Chinese leaders recognize the challenges facing the nation and, for the most part, seem prepared to address them. Policy initiatives exist to diminish energy intensity and improve emissions standards.

Many challenges remain, such as water, which is being polluted and depleted rapidly in some northern cities. The ability to preserve social stability will be critical, especially if the price of water and electricity is raised. The Chinese recognize the environment and food security as increasingly important issues. The rule of law and transparency will be equally important, especially for investors. The investors at this seminar agreed that the risks in China are not necessarily more severe than in many other developing countries, but the difference is that both the opportunities and the exposure in China are much higher. As one investor said, “if you don’t get China right, nothing else matters.”

* * *

¹ This paper provides a summary of some of the key points raised in this Workshop on Political and Economic Stability in China, which was held at the Carnegie Endowment for International Peace on January 24, 2006. The Workshop was sponsored jointly by the Center for Strategic and International Studies, the US Chamber of Commerce, the Business Roundtable, the Intelligence and National Security Alliance, the Office of the Director of National Intelligence, and the US Department of State’s Bureau of Intelligence and Research. It was organized to solicit the views of non-governmental specialists and to facilitate the exchange of views between the outside specialists and government officials. The workshop was conducted on an unclassified, off the record, and not for attribution basis. The views expressed in the discussions and in this summary are solely those of individual experts who attended the event and do not necessarily reflect the analysis, views, or opinions of any company, consortium, or US Government agency.

The Interface Between Political Reform and Economic Decisionmaking.

Speakers agreed that political reform and economic decision-making and prosperity are inextricably intertwined in China. They identified four key political risks to continued economic growth and to foreign direct investment:

- *The failure of the government to manage a major crisis that would affect financial risks.* China faces many challenges (environment, health, inflationary/deflationary processes, weakness of financial institutions, etc) and given a trigger, a crisis in any one of these areas could be mismanaged. There could be divisions in leadership about how to respond or poor response due to corruption.
- *The adoption of anti-market policies.* China is investment-friendly now because it has made pro-market decisions. Government reactions to political protests or Chinese perceptions of unfair treatment by investors could lead to reversals.
- *The risk of adoption of policies that embody economic nationalism.* There is a widespread sense that foreigners are doing too well, and many want Chinese firms to do better. A combination of offensive and defensive policies might include antimonopoly measures that discriminate against foreign firms, local (rather than international) technical standards, municipal financing of factories leading to over fabrication, subsidization or the promotion of Chinese firms to capture more of the value chain from research and design, or the aggressive promotion of Chinese firms to go global. Anti-foreign feelings and a hostile press could make the ability of foreign firms to seek redress through the judicial system even more difficult, especially with the absence of discovery proceedings and rules for expert witnesses.
- *Bilateral tensions.* This can include export controls, asset blockages, embargos, retaliatory duties, etc. Tensions over Taiwan, historical friction with Japan, and potential fallout from the unanticipated diplomatic or military incidents are always just below the surface.

Despite these continuing risks, there has been continuity of leadership in China and political stability for the last twenty years, and the speakers agreed that is unlikely to change. There will, however, be a certain amount of social instability and tension until the country achieves a more widespread gain and greater equity in the standard of living. Continuing disparities between growth and prosperity in coastal and interior regions, and between urban and rural areas, and between rich and poor, could contribute to these tensions. For Chinese leadership, the most worrisome risk is the increasing stratification of classes. Anger over environmental issues or corruption also could lead to political tensions.

One speaker identified several indicators to watch. He argued that if they occur simultaneously, these catalysts could create a kind of “perfect storm.” Although

unlikely, this “perfect storm” might lead to political instability that could threaten economic reform. These indicators are: widespread anger and desperation among a large segment of the population over one or more critical issues (caused by a bank collapse, a widespread pandemic, etc.); a weak or badly divided leadership; loss of party control over the key levers of power (e.g., the army or police); and the development of an organization or leadership structure that is able to channel discontent into some kind of revolutionary movement to overthrow the government. Generally, however, the assessment was that, barring this kind of unlikely “perfect storm,” China will be able to muddle through its problems without threatening the political stability of the system. The speakers agreed that the Chinese political leadership has been careful to prevent these kinds of threats from converging, and that they are likely to continue to work through the nation’s problems to prevent the perfect storm.

Despite the prediction of continued political stability, conference participants identified several trends that may affect how investors look at China:

- *Demographics.* Like Japan and Western Europe, China is becoming much older rapidly. By 2030 it will look like Japan today. Net additions to the work force will decrease. As labor markets tighten, there will be pressure for higher wages. This could lead to a push toward a unified labor market and perhaps even a national labor movement with significant impacts for foreign investors.
- *Government spending.* The government’s share of GDP will continue to rise, and the nature of most problems will be related to providing public goods and solved by increased government spending. This could lead to higher taxes that may be levied disproportionately on foreign firms. Higher domestic taxes also could lead to calls for more influence at the local levels in China, thereby increasing tensions with the center.
- *Political transparency.* Central leadership will face demands for more people-focused development, perhaps leading to a greater respect for human rights. Examples include rural village women protesting about property rights. Constitutional rights protests are becoming more common in China, and a competent, functioning, impartial court system will become increasingly important. Whether and how Beijing adapts will affect stability greatly.

Assessing Financial and Operational Risk in the Chinese Market.

Speakers viewed economic trends in China as generally favorable. They argued that the Chinese leadership likely will continue its policies of incremental reform started in 1989. The nation's future economic development will continue to be fueled by the rapid growth of fixed asset investment, backed by the high savings rate and a continuing large inflow of foreign direct investment. Rapid economic growth continues (at an annual rate of 8-10 percent), profitability of Chinese banks has been trending upward and most are now solvent (with “mega-banks performing better than city banks), non-performing loans are down, and there has been a rapid improvement in capitalization.

The ratio of central debt to revenue has been decreasing, and this means more stability for the Chinese economic system. Profitability for Chinese companies is growing, despite stress and overcapacity in certain sectors such as automobiles. Still, a lack of access to funds has retarded the growth of private firms. Progress in the reform of the banking sector has not been matched in the securities and other financial sectors. Looking forward, the challenge for reformation of the financial sector will be reducing the number of nonperforming loans. Liberalization of interest rates also will be a challenge; currently banks make little money on loans, considering the spread.

Speakers identified five financial and operational risks for investors in China: regulatory risk, receivables risks, the nexus between intellectual property rights and standards, human resources challenges, and tightening margins due in part to subsidies. At present, the delicate balance continues between encouraging foreign direct investment and conditioning investment on helping Chinese companies. The Chinese want the knowledge that foreigners bring into the process, but not the control. One investor commented that companies that move to China to produce for export succeed, but those that try to sell in the domestic market do less well.

Progress in the judicial system was recognized, but there was general agreement that the system can never be considered independent as long as it is a subsidiary of the Communist Party. One speaker argued that the Chinese have limited capacity to enforce intellectual property protections. While Chinese companies themselves may eventually press harder for it, there should be no assumption that intellectual property protection will increase rapidly. The speakers didn't see inflation as a serious problem, even though the government is seeking to slow it in the real estate and some other sectors. The economy must grow at eight percent to provide jobs for employees entering the job market. Despite this generally favorable outlook, speakers felt that China's current rate of growth cannot be sustained indefinitely, leading eventually to some pain as the economy slows.

Assessing Energy and Environmental Constraints on China's Future Growth.

China is one of the world's worst polluters of air and water. It is the largest importer of illegal lumber and the biggest polluter of the Pacific Ocean. It needs to secure energy, create jobs, and increase growth at the same time it significantly improves the environment. The good news is that there has never been a time that the government has taken the challenge as seriously as it does now. It sees the environment as impinging on economic growth, e.g. pollution-damaged crops, and it is aware that public health is suffering. Over 400,000 Chinese die early each year due to respiratory problems. And finally, there is concern that social unrest can occur. In 2005 there were 80,000 protests, 50,000 of which were environment-related.

Despite these concerns, other pressures may limit progress on controlling environmental degradation. With GDP and population growth will lead to an increase in energy demand of 3 percent annually. Liquid fuel and coal usage will grow sharply, and by 2030, over half of global demand for coal will be in China; very little energy will

come from renewable resources. China will not accept slower economic growth for carbon dioxide reductions. According to the speakers, China needs to focus on building more energy efficient buildings, creating meaningful incentives for conservation, and strictly enforcing penalties for violations. Fines are too low, and wastewater gets dumped into rivers because it's too expensive to run plants otherwise. They also argued that the price of water needs to be increased to promote conservation. China has become increasingly interested in renewable fuels, and opportunities for clean fuel technologies will increase even as China remains dependent on coal. Positive signs include development of coal scrubbers, establishment of regional offices to address pollution issues with national standards, and other policy-driven measures. Results so far have been inconclusive, however.

Food security is a growing concern for the Chinese government. China eventually can become a more efficient producer, but food self-sufficiency is not really feasible. As China develops, caloric consumption is expected to increase, in addition to a diversification of the diet. Deficits in production can be overcome through trade. For greater self-sufficiency access to clean and adequate water supplies will be critical, and the Chinese will need to address such issues as land rights, food safety policies, cooperatives, price risk mechanisms, etc.

Assessing Innovation in the Chinese Market.

The speakers were generally optimistic about China's ability to innovate in the longer run. They do not see China as a global "techno-superpower" in 20-30 years capable of broadly challenging the United States economically, but they do see it as leading in certain niche areas. A lack of experienced personnel, however, means earlier promotions and could create a talent war in the short to medium term. While research and development is strongly supported, the Chinese patenting record is disappointing. The numbers of scientists and engineers engaged in R&D in China are large (over 900,000) and growing, though still low per capita compared to most developed countries. The percentage of engineers is decreasing as they shift into other fields, despite a big push to train them.

On the positive side, access to inputs such as capital, expertise, management, and skilled labor is growing in China. The incorporation of information technology in Chinese society has been rapid. There is a movement away from support for state sector enterprises and toward more private sector, market-oriented firms, which are more focused on becoming innovative. Despite a lack of access to funds that has retarded the growth of private sector companies, they have become an engine of economic growth, are twice as profitable, and generate most of the GDP. They do all that as small to medium size enterprises; there are few large private companies. Numerous research centers, run by international companies in China, enable more research and rapid growth. Chinese students returning from education abroad have been very effective innovators. One on-the-ground investor remarked that over the past five years the experience of his company has been that quality of workers in China has increased greatly. Another investor noted that people coming out of school in China still are not ready to innovate in most cases,

but that given a few years “the Chinese can be as innovative as workers anywhere else in the world.”

The Bottom Line: Healthy Competition Within Limits.

According to the investors, the Chinese government is likely to continue to encourage healthy competition and will make conditions profitable for them, despite relatively strong nationalistic impulses. In the long term, China will remain attractive to foreign investors and foreign investment will be critical to China’s development. One speaker said the risks of operating there are “manageable” for investors who are nimble and who respect Chinese sensibilities, e.g., by not pressing too hard on intellectual property rights and who accept Chinese preferences for its own industry in terms of taxes, etc. There will be challenges in obtaining a well trained and innovative labor force, and as wages rise it may be more advantageous to move on to other markets for some industries. Foreign investors must be alert to change, adaptive, and willing to work with the Chinese to address their problems with energy, pollution, water, and food security. Patience will be required as improvements in the legal system proceed slowly. In twenty to thirty years, China is likely to be a formidable but not a seriously threatening economic competitor for the United States.

February 16, 2007