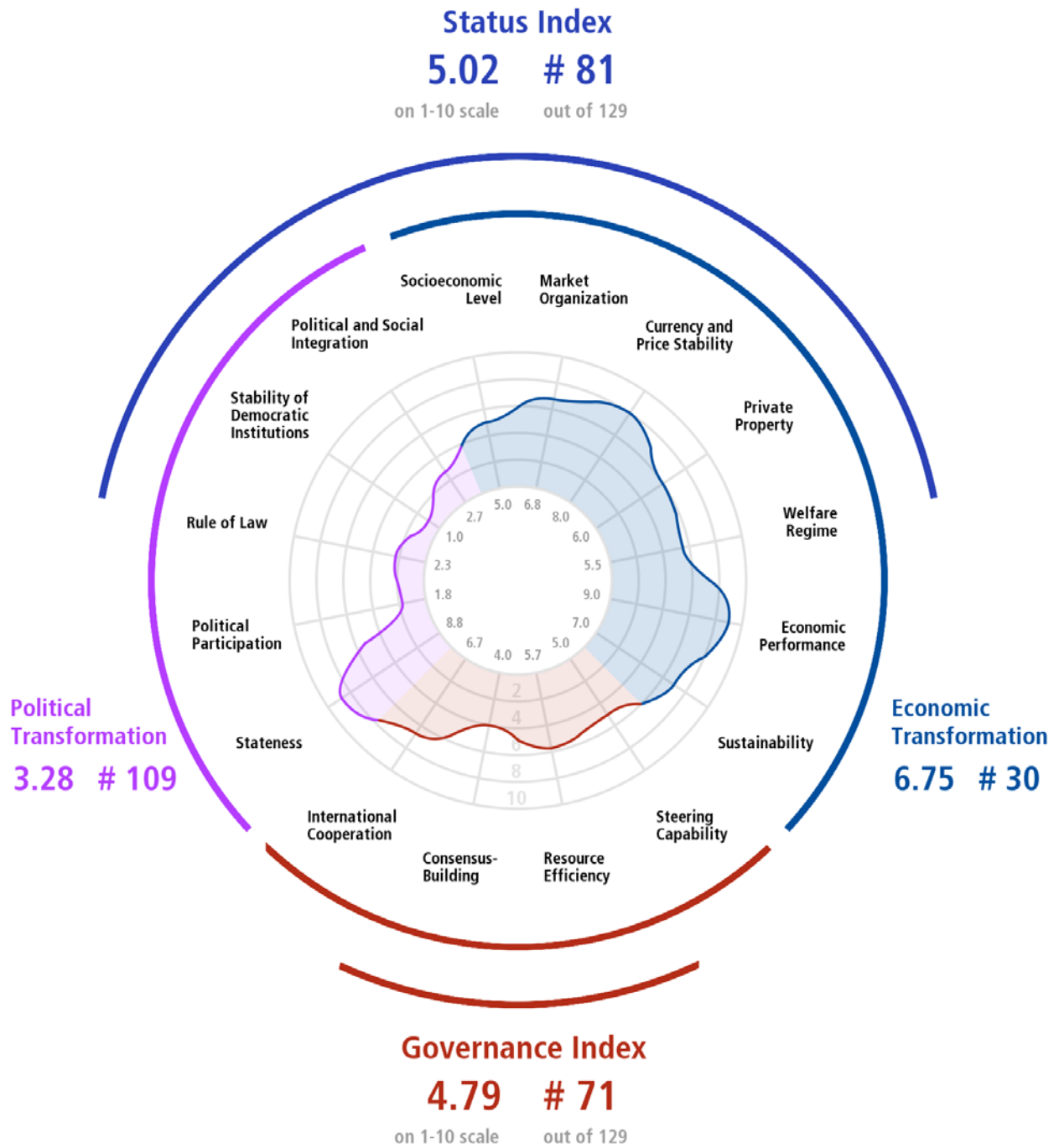


China



This report is part of the Bertelsmann Stiftung's Transformation Index (BTI) 2018. It covers the period from February 1, 2015 to January 31, 2017. The BTI assesses the transformation toward democracy and a market economy as well as the quality of political management in 129 countries. More on the BTI at <http://www.bti-project.org>.

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Key Indicators

Population	M	1378.7	HDI	0.738	GDP p.c., PPP \$	15535
Pop. growth ¹	% p.a.	0.5	HDI rank of 188	90	Gini Index	42.2
Life expectancy	years	76.1	UN Education Index	0.663	Poverty ³	% 12.1
Urban population	%	56.8	Gender inequality ²	0.164	Aid per capita	\$ -0.2

Sources (as of October 2017): The World Bank, World Development Indicators 2017 | UNDP, Human Development Report 2016. Footnotes: (1) Average annual growth rate. (2) Gender Inequality Index (GII). (3) Percentage of population living on less than \$3.20 a day at 2011 international prices.

Executive Summary

Developments during 2015 and 2016 defy simple characterization. The government has continued to be responsive to a wide range of social interests and to implement measures to improve public service provision. At the same time, the government tightened the screws on any form of dissent. It implemented a series of laws and regulations that further constrain civil and political liberties, including the National Security Law, the Foreign NGO Law and a Cyber Security Law that will go into effect in the second half of 2017. Communist Party of China's (CCP) General Secretary Xi Jinping also effectively ended the debate of how to reconcile one-party rule and the rule of law, a discourse initiated by Xi himself. In 2015 and 2016, at least 248 human rights lawyers who tried to hold the government accountable to its own standards were rounded up and imprisoned on trumped-up charges of subverting state power. The review period also saw the abduction of foreign nationals from non-Chinese territory to put them on trial in China, often accompanied by televised "confessions." Xi also made it very clear in speeches that the CCP stood above the law, thereby legitimizing the use of drastic and illegal measures to intimidate intellectuals, scientists, lawyers and NGOs.

A similar picture presents itself with regard to China's external relations. In the reporting period, trade barriers were further reduced, intellectual property better protected and the government used a significant part of its foreign exchange reserves to prop up the Chinese Yuan (CNY) against an appreciating dollar, ostensibly to prevent capital flight and bolster confidence in the currency's future. Although China has become more accommodating to demands that the country open up its economy and improve its legal environment, it has remained assertive in international relations, especially with respect to its activities in the East and South China Seas. As regards the former, both China and Japan have increased their military presence in the region, heightening the risk of military conflict. Trilateral talks between China, Japan and Korea have acknowledged the need to cool down the conflict, but have fallen short of producing a solution. In the South China Sea, China continued its construction of artificial islands in the Spratly archipelago, encroaching on territory claimed by the Philippines and Vietnam. In 2016, the Permanent Court of Arbitration in The Hague

ruled that China had no historic claim on the territories it occupied in the South China Sea, but China refused to accept the ruling.

Domestically, the government continued the struggle against the challenges of economic slowdown, environmental pollution and what some regard as a mounting debt crisis. Most notably, the 13th five-year plan (2016-2021) introduced measures to develop China's service sector and improve its environmental balance sheet. This comes at a time when exports dropped sharply (nearly 14%) and GDP growth fell below 7%. China's financial sector also displays worrying tendencies: the shadow banking sector has grown considerably during the review period and national debt has increased too quickly, enough that observers warn of an impending crisis. However, the government has reacted to these trends by further regulating wealth management products and trust loans, the main components of the shadow bank sector.

History and Characteristics of Transformation

Economic transformation in China was initiated through the "Opening and Reform" policy introduced in 1978. After the upheaval of the Cultural Revolution, the Chinese leadership emphasized economic and political consolidation. Despite initial structural deficiencies and distortions, economic reforms benefited from preconditions seldom found in developing countries: the large rural workforce facilitated the recruitment of cheap labor for the emerging industrial sector, and the government expropriated land at low or no compensation, which further served to keep factor costs low. Despite the existence of a planned economy, the public sector remained rather limited. Overseas Chinese from Hong Kong and Taiwan were eager to provide scarce capital and managerial know-how as soon as the Chinese leadership decided to experiment with foreign direct investment. These specific circumstances considerably facilitated economic development. Consensus among the leadership to determinedly follow the Opening and Reform policy drove economic reforms. However, since the Tiananmen massacre in 1989 when the People's Liberation Army (PLA) violently cracked down on a protest movement initiated by students, there have been no attempts to increase political competition or even initialize a transition to liberal democracy. In the aftermath of the "incident," which remains a taboo topic in China, political reformers were purged from the CCP leadership and since then, party and state elites have been united in their commitment to limit reforms to the socioeconomic area and allow political reforms only in the administrative sector, enhancing governance, but not democracy. Economic reforms and decentralization during the same period have proceeded gradually and been subject to experimentation. In this way, China has avoided the transformational "shocks" that occurred in the Russian Federation, for example. Absent a detailed roadmap, the Chinese leadership allowed for reform initiatives from lower administrative levels to be implemented locally and by way of trial-and-error. If successful, these local initiatives were adopted as national policies. The leadership's decision to let a planned economy and the gradually emerging private sector coexist has proven most important in maintaining economic stability. During the reform process, the de facto economic importance as well as the political appreciation of the private sector increased

steadily. Economic reforms were accompanied by yearly GDP growth rates of about 10% from 1978 to 2010 and, with the exception of two spikes in 1988 and 1989 (18%) and 1994 and 1995 (24%), relatively low levels of inflation. Growth rates have declined after the global financial crisis from 2008 to 2010 and the ensuing global recession. Living standards have improved significantly, and the number of absolute poor has decreased by 300 million from 1978. This overall success is clouded by the increasingly uneven spread of wealth. Urban incomes today are more than three times those of rural incomes, and the Gini index (officially 0.474, by some measures even as high as 0.61) reveals that, even by the standards of other emerging markets (for example, countries in Latin America or South Africa), China now has one of the most unequal societies in the world. Corruption, a semi-functional legal system, and a lack of sustainability in economic development constitute other serious problems. The deterioration of the environment is causing enormous economic and social costs and constrains further development. In addition, the Chinese government is increasingly under pressure to fulfill the demands of the population for better public goods (reliable social security, health care and pension systems, a working infrastructure), affordable housing, career opportunities and a more accountable government. There have been increasing numbers of cases of social unrest by people who, devoid of access to institutionalized channels to express their grievances, resort to riots and violent clashes with authorities to make their case. Middle-class intellectuals also routinely voice skepticism about regime policies on the Internet. The current leadership headed by CCP General Secretary Xi Jinping (chosen at the 18th Party congress in November 2012 and beginning his second term in fall 2017) seems determined to stick to the overall policy line as set by his predecessor: no longer to concentrate exclusively on economic growth but also consider the often-negative social consequences of economic development. While some changes in policy style have been notable in the immediate aftermath of the party congress, the Xi leadership has demonstrated that it does not have any intentions to engage in meaningful political liberalization.

The BTI combines text analysis and numerical assessments. The score for each question is provided below its respective title. The scale ranges from 1 (worst) to 10 (best).

Transformation Status

I. Political Transformation

1 | Stateness

There is certainty about the nation's existence as a state. Challenges to the state come from secessionist movements in the autonomous regions Tibet and Xinjiang, as well as from pro-democracy forces in Hong Kong. While no official armed opposition challenges the government in Tibet, clashes between armed militants and Chinese security forces have left more than 100 persons dead during the review period. Although there were no large-scale uprisings as in 2009 or 2011 during the review period, smaller, but violent, confrontations did occur. In 2015, militants attacked a coal mine, leading to a raid by Chinese security forces that, according to official sources, killed 28 suspects. For 2016, there are no reports of large-scale operations, likely resulting from the very heavy Chinese security force presence in the region. As for Hong Kong, pro-democracy forces continue to challenge China's sovereignty over the territory two years after the Umbrella Movement, in which millions took to the street to protest China's denial of universal suffrage in the 2017 chief executive elections.

According to the Chinese constitution, China is a unitary, multiethnic state. Most citizens seem to accept and support the People's Republic of China as a legitimate sovereign nation state. Taiwan is officially considered a part of China by the governments of both Taiwan and China, but the two sides are in disagreement who represents China - the Republic of China on Taiwan or the People's Republic of China on the mainland. The "agreement" that there is one China, but different interpretations of who represents China forms the basis of the so-called 1992 consensus. The Chinese government is periodically pressing Taiwan to make preparations for unification, whereas the Taiwanese policy is to make the initiation of unification negotiations dependent on China's democratization. In contrast to previous elections where the Democratic Progressive Party (DPP) was a serious contender for political office, China did not interfere into Taiwan's 2016 election. In China, minority rights in self-governance and representation, economic autonomy, educational autonomy, religious freedom, cultural expression, language use and

Question
Score

Monopoly on the
use of force

9



1

State identity

8



1

freedom from discrimination are guaranteed by law. In practice, however, enforcement of the law is very uneven and this has led to considerable pressure from Tibetan and Uyghur secessionist movements, which have become more and more frustrated with their lack of effective political and cultural minority rights and equal opportunities in economic life. Violent mass uprisings, such as in March 2008 (Tibet) and July 2009 (Xinjiang), were prevented in the review period by a massive deployment of security forces to the regions. The number of Tibetans who have self-immolated in protest (146 between March 2011 and December 2015, 3 in 2016) has decreased in the review period.

The state is defined as a secular order; religious dogmas have no influence on politics and/or the law. Only five religions – Protestantism, Catholicism, Buddhism, Daoism and Islam – are officially recognized and strictly controlled through organizational means (nationwide associations for religious purpose). With the proceeding erosion of communist ideology as well as traditional Chinese family values, people yearn for spirituality. Thus, all kinds of religion, including folk religion and ancestor worship, attract more and more adherents. The government had long been tolerant of the revival of these various forms of religion in the belief that it will foster social cohesion. Especially noteworthy is the spread of Christianity with an estimated 80 million followers, many of whom congregate in illegal house churches. While it had long been the case that only house churches faced occasional harassment, this situation has changed in the reporting period. Starting in July 2016, the Chinese authorities began large-scale demolition work at the Buddhist Institute in Larung Gar, which is believed to be the largest Buddhist institute in the world. According to official statements, the demolitions are a part of Larung Town's urbanization drive and should serve to modernize the institute. In the province of Zhejiang, the authorities continued to remove crosses from church buildings by order of Party secretary Xia Baolong. According to local estimates, 1,700 churches have had crosses removed between 2013, when the campaign started, and early 2016. On September 8, 2016, draft Regulations on Religious Affairs were released by the central government, subjecting religious organizations to stricter controls. Among other measures, donations by foreign entities will be under greater scrutiny than before if the law is passed in the attempt to minimize foreign influence. However, the document is also meant to close regulatory gaps in order to manage (and restrict) activities that previously had not been clearly regulated.

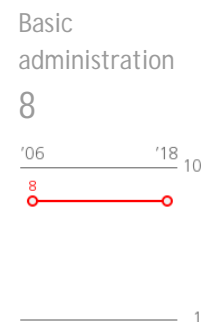
No interference of religious dogmas

10



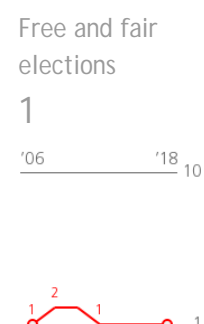
1

In China, a fundamental and sufficiently differentiated bureaucratic structure extends over the entire territory. In a few rural areas, however, the public infrastructure is still weak and access to basic utilities remains inadequate. Furthermore, priority conflicts among different layers of the administration exist. As each administrative unit controls only the next lower level, it is difficult for the central government to ensure that national policies that need to be contextualized are implemented correctly at the city, county and township levels.

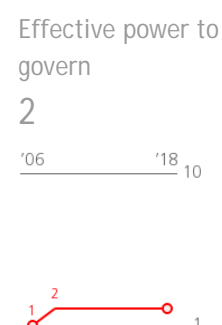


2 | Political Participation

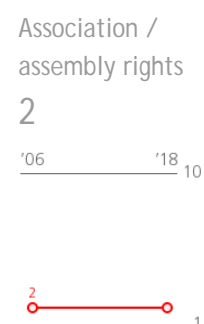
National level authorities are not selected by free and competitive general elections but are generally chosen by the Organization Department of the Chinese Communist Party. Indirect elections, in which People's Congresses elect the congresses at the next higher level, and the National People's Congress elects the leaders of the executive, merely serve as a procedural legitimization. At the local level, limited venues for participation, such as elections for village and urban residents' committees as well as village leaders and party branch secretaries, and experiments with primaries and elections for township-level legislatures and party secretaries exist. However, only in some areas do they function as democratic experiments, whereas in the majority of the localities they are used as an instrument to ensure effective working relations with the higher administrative entities and to aid policy implementation. Thus, nomination of candidates, voter eligibility and election campaigns are subject to local government and party control; manipulation is widespread.



The political authorities have the effective power to govern and are not overruled by veto powers. The military is under control of the civilian party leadership. However, rulers at the central level are not democratically elected – the elections that do take place are a facade. Instead, delegates to the national legislature (the National People's Congress) and all leading political and government positions are filled by an internal selection process controlled by the Communist Party. This selection process however is the result of a complicated compromise between different interest groups (networks) inside the Communist Party.



Although freedom of association and assembly is guaranteed by the constitution, the state heavily interferes with this right. The number of registered civil society organizations in China has increased from 153,322 (2000) to 662,425 (2015), but these organizations are not allowed to operate independently; instead, they need to find a governmental host organization and then subject themselves to demanding procedures to obtain registration with the Ministry of Civil Affairs or its local counterparts. This severely restricts their autonomy. Political organizations competing with the CCP, for example, "opposition parties" such as the China Democratic Party, are prohibited. Eight minor parties exist legally, making the system



formally a multiparty state under the leadership of the Communist Party in a United Front. Since the government fears that stronger NGOs could limit state control over society, only NGOs with a non-political agenda are tolerated and even supported by the regime. Such NGOs can help the government to shoulder responsibilities such as emergency relief after natural disasters, or provide social services where the adverse effects of economic development have negatively affected people's lives (such as issues of environmental protection; health care/AIDS; support for the disabled and orphans). The government is increasing its control over NGOs by regulating their access to financial resources. Most notably, there has been a tendency of isolating domestic NGOs from foreign influence by making it more difficult for external donors to support domestic NGOs. At the same time, a new charity law (passed in March 2016) allows NGOs to raise funds domestically, albeit only with government approval. Finally, an overseas NGO law went in effect in January 2017. The law requires foreign NGOs who wish to operate in China to obtain a permit from a Public Security organization, as well as find a Chinese partner (for temporary activities) or establish an office (long-term activities), which in turn requires approval of the Professional Supervisory Authority in the NGO's field, which in most cases will be a government agency.

Although guaranteed by the constitution, freedom of expression is still severely curtailed. Still, Chinese citizens increasingly make use of the Internet, social media and other mass communication technologies to express critical views, raise public awareness and criticize government actions. The government reacts to this challenge with tightening controls on these technologies, for example by shutting down critical websites, blocking text-message services and censoring online content; moreover, the email and phone communications of political activists are monitored, as is allegedly the Chinese version of online telephony company Skype. This has resulted in the detention of several "bloggers" and "cyber-dissidents." Most television, radio and print media are controlled and/or owned by state organs. The Open Net Initiative classifies China's internet censorship and surveillance as "pervasive". Control was tightened even more in 2016. In February that year, CCP General Secretary Xi Jinping toured state media outlets and stressed that he demanded absolute loyalty to the CCP. The work of journalists is censored by the CCP, earning China continuously low ranks in the World Press Freedom Index of Reporters Without Borders (rank 176 out of 180 countries in 2016). Foreign media companies also face frequent discrimination and are blocked after critical reports. Since March 2016, foreign media are not allowed to publish content online in China without government approval. In addition, such content must be hosted on Chinese servers. With formal channels of expression severely limited, people take their grievances to the streets. The number of protests and public disturbances has steadily increased and was estimated to stand at 180,000 in 2010. Although protests are common, this figure should be read with caution, because it is very difficult to verify and to evaluate. The overwhelming

Freedom of
expression

2

'06 '18 10

2

1

majority of these protests, however, seem to involve very few people and target social problems (not political change).

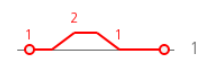
3 | Rule of Law

The political system is characterized by the Leninist principle of concentration of state powers with the National People's Congress (NPC) as the formally highest organ of power. In principle, all state organs, the executive and the judiciary at the central level as well as at the local levels, are responsible to the NPC or local People's Congresses, respectively. Thus, the constitutional framework does not establish a system of separation of powers. Since the CCP is constitutionally defined as the supreme ruler, it commands state institutions, and the NPC and local People's Congresses are subject to CCP directives and control. Hopes from abroad that the NPC or local congresses might play a more independent role have not materialized. Although the rule of law has been enshrined in the constitution, the CCP remains above the law and has been willing to engage in only what is officially referred to as "governing the country according to law." In the review period, the discourse on law reform came to a preliminary end, despite the greater professionalization of the judiciary fostered by the leadership and some efforts to give courts more independence from local governments. However, independence here means to isolate local prosecutors and judges from social connections, which divert local legal officials from following the central party authorities' rules. As well, practice in the field of civil rights and criminal justice has become more repressive, according to experts. Thus, the government uses the law as a convenient way to govern; the central role of the law is to maintain social order; and the CCP as an organization trumps the law. A serious system of checks and balances does not exist.

Although the judiciary is institutionally differentiated, there exists a considerable lack of judicial independence. Despite the leadership's repeated vocal commitment to the rule of law, China's legal system remains tightly under the control of the CCP and interference with the work of the judiciary still occurs frequently. Particularly within the lower level courts, judges are very susceptible to corruption. The bar lacks independence, as the All-China Lawyers Association is institutionally subordinated to the Ministry of Justice. Particularly in criminal cases and defense of rights cases, lawyers are curtailed when performing their duties, especially in conducting investigations and gathering evidence. In addition, lawyers are often harassed when representing defendants in human rights cases. Since 2007 when the authority to review death sentences was given back to the Supreme People's Court, the number of death sentences and immediate executions has dropped significantly, although it is still considered the highest in the world.

Separation of powers

1
'06 _____ '18 10



Independent judiciary

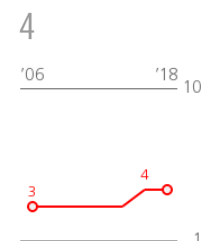
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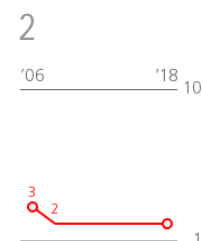
Although laws against corruption are in place, they are rarely enforced, except in the form of campaigns. One such campaign took place during the review period. This campaign followed the established practice of corruption being investigated by the Communist Party's Commission for Discipline and Inspection, which has gained in importance; dozens of high-ranking officials (above the rank of vice-minister) have been targeted, but merely a fraction of cases are submitted to the state judicial organs for prosecution. While it seems that the party leadership is concerned about the spread and levels of corruption and correctly sees this as one of the major stumbling blocks of regime legitimacy and effectiveness, the logic of political survival through distribution of spoils and privileged access to exclusive goods (as in any single-party regime or dictatorship) means that problems of corruption and shortcomings of anti-corruption efforts are systemic. During the review period, office abuse was prosecuted more rigorously than before, but corruption also remained a potential and powerful political tool. The anti-corruption purge initiated by the Xi Jinping administration targeted officials at all levels and in all sectors of the regime: party, government, representative organs, universities, state-owned enterprises and the military. Anti-corruption laws have become stricter, imposing limits on the gifts officials can receive and the amounts of money they can spend on official banquets. In 2015, Zhou Yongkang, the former head of China's public security apparatus, was convicted on charges of abuse of office and sentenced to a lengthy prison sentence. Foreign media reports, which made their way into China and targeted the huge personal wealth accumulated by the families of leading party cadres (including family members of Xi Jinping), have shattered the stereotype that corruption does not affect the top leadership and is only a local phenomenon. One example during the review period is the release of the Panama Papers, which revealed that family members of Chinese leaders had stored large amounts of money in offshore accounts. Anti-corruption campaigns do not only affect the political realm. During the review period, "petty corruption" in the form of demanding bribes for services has become more difficult. Service providers are monitored with computer programs and even video cameras, and the electronization of financial transactions has imposed additional barriers to corrupt behavior. Also, the government has sought the assistance of Interpol to find fugitive government officials who have allegedly committed financial crimes.

The constitution guarantees certain civil rights, such as freedom of speech, of the press, of assembly, of association, of demonstration, of religious belief, of person and so on. Nevertheless, the CCP and state organs frequently interfere with these rights. For example, religious/spiritual groupings, such as underground Protestant churches and Catholic communities' allegiant to the pope, are not tolerated by the authorities in many places and activists are frequently persecuted. Maltreatment, physical abuse and torture of prisoners are prevalent. In rural areas, the state is not willing or able to prevent large-scale human rights violations by private actors, resulting in widespread forced labor, abductions and human trafficking. Forced resettlement due to large-

Prosecution of office abuse



Civil rights



scale governmental construction projects or illegal land grabs by local authorities violates people's property rights. Ethnic minorities are often politically and economically discriminated against, since public and economic life is dominated by Han Chinese. Minority regions enjoy de jure regional autonomy to some extent, but de facto lack significant autonomy rights. Although the Chinese constitution stipulates that both men and women enjoy equal rights and legislation for the protection of women's rights has been in place since 1996, in practice, women's rights and opportunities are still severely compromised in many parts of China. While in principle, victims can seek redress for such violations, corruption and the lacking independence of the judiciary hampers the efficacy of these mechanisms

4 | Stability of Democratic Institutions

The formal arrangement of political institutions is characterized by the supremacy of the CCP; thus, the People's Republic of China (PRC) can be classified as being an authoritarian political system dominated by the CCP. The majority of leading political actors are recruited from within party ranks, but some high-ranking politicians can be recruited from the eight legally-recognized minor parties, such as the current Minister for Science and Technology, Mr. Wan Gang of the China Zhi Gong Party. Political organizations in competition with the CCP are forbidden and suppressed. There are no democratic national elections through which the people could change the government and there is no intention to implement such elections. The judiciary is not independent; especially in "sensitive" cases involving public disturbances, state secrets or product safety, political involvement in the judicial process is frequent.

Political leaders have endorsed the direct elections of village and urban residents' committees and encouraged greater transparency and popular participation in local governance. However, these measures are not intended to influence developments at the central level, but aim instead at improving good governance and strengthening party supervision. In addition, these elected bodies are not part of the government's formal administrative system. Democratic election procedures at the township level (the lowest level of the administrative hierarchy) had been permitted, but officially were suspended in 2006 after only eight years of experimentation. Even though intellectuals affiliated with government think tanks and some high-ranking CCP cadres have talked about the virtues of democracy for China (and have come up with labels such as "incremental" or "orderly" democracy), these should not be mistaken as a future commitment to political reform toward a multiparty liberal democracy. Quite to the contrary, on many occasions, the dominance of the CCP and the socialist system is promoted while Western-style democracy is repudiated.

Performance of democratic institutions



Commitment to democratic institutions



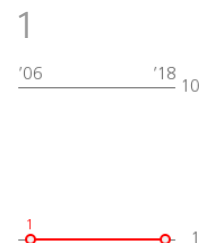
5 | Political and Social Integration

The party system is dominated by the CCP; even though eight so-called democratic parties are officially recognized, they are subordinated to the CCP. CCP membership has grown to almost 89 million (by the end of 2016), the proportion of private entrepreneurs, self-employed and college graduates being disproportionately high among new members. This means that the new urban middle-class, as the “winner” amid China’s many economic reforms, now constitutes the country’s most important social base and the backbone of the CCP. In other words, the party tries to integrate, or coopt, relevant social groups to avoid alternative political mobilization. Peasants and urban industrial workers in turn have become increasingly marginalized in political and economic terms.

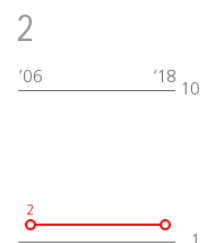
In China, the system of cooperative associations is very heterogeneous and characterized by differences in the relationship to the state. Mass-organizations such as the All-China Federation of Trade Unions, the All-China Women’s Federation, or the China Youth League are funded, controlled and supervised by the state and mainly operate as purveyors of CCP policies to respective membership groups. Several interest groups have been established on the initiative of the state and count as “GONGOs,” that is, government-organized non-governmental organizations. There also exist NGOs which concentrate mainly on social issues, such as environmental protection, animal welfare, representation of the interests of marginalized groups (women, the disabled, ethnic minorities, children), and provide services, such as legal aid and consumer protection. Homeowner’s associations and business associations, which represent the interests of well-off strata in Chinese society, often have an impact on local politics. China has a thriving state-approved non-profit sector, in which informal, non-registered associations (an estimated 2 million) are active in areas such as environmental protection, alumni activities or self-help. However, NGOs are poorly connected, lack organizational capacity and funding. As the state tightly controls the working of social associations and rigorously bans politically undesirable NGO activities, large segments of interests remain underrepresented. The government has begun limiting the influence of foreign donors on domestic NGOs, many of which had been dependent on foreign funding and were accused of having their agendas shaped by donor interests. At the same time, the new charity law (passed in 2016) gives domestic NGOs better access to domestic funds, albeit under increased government control.

Many Chinese have only vague ideas about democracy and often reveal a conflicted understanding about what the concept means. According to the World Values Survey, Chinese generally think positively about democracy; almost 90% consider having a democratic government a good thing. This attitude partly stems from the fact that the Chinese government calls itself democratic. However, the broad interest in a responsible, incorrupt and predictable form of government has not yet led to demands

Party system



Interest groups

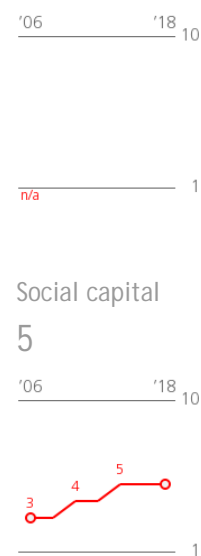


Approval of democracy

n/a

for political participation. Even if many Chinese today are ready to strongly criticize governmental arbitrariness and officials' chicanery, the overwhelming power of the state frightens off any demands for democratic participatory rights or attempts to become personally engaged in politics. Additionally, the argument of the leadership that a strong state/government is needed in order to guarantee economic development and prosperity is widely accepted.

According to the World Values Survey, the level of interpersonal trust is extremely high in China and is almost on par with the level encountered in Scandinavian countries. In China, 60.3% of the respondents affirmed the statement "Most people can be trusted". Parochial trust, that is strong loyalties between family members, is particularly pronounced – 85.5% of respondents trust family members "completely". Civic trust is also growing, as citizens affected by severe problems such as environmental degradation, local government corruption or violations of basic human rights, associate for purposes of self-help. Occasionally, these associations are supported by activist lawyers. These groups are closely watched; and since they often aggressively bring social ills and wrongs to the fore, local governments, in particular, try to silence them by repressing leaders, activists and lawyers. Protesters are often financially compensated by local officials who mediate in situations that could endanger political stability.



II. Economic Transformation

6 | Level of Socioeconomic Development

China's GDP has continued to grow, albeit at a smaller pace than in the previous years. The structural transformation of the economy from industry to services and from capital investments to consumption have not affected China's social development and inequality to a large degree. According to official statistics, the overall distribution of income, measured by the Gini coefficient, was 0.422 in 2012, which likely is a conservative estimate. Wealth distribution is even more unequal: according to a report by Beijing University, 1% of China's households owns one-third of China's wealth. Between 1995 and 2012, the Gini coefficient for household wealth increased from 0.45 to 0.73. Given the absence of a unified national poverty line and statistical manipulation in local governments, China's poverty rate is difficult to pinpoint. According to the senior official in charge of poverty alleviation, 82.49 million people, or 6% of the population, lived in poverty in 2013. This roughly tallies with World Bank statistics when 1.25\$ PPP is applied (2014: 6.3%). If the poverty line is set at 2\$ PPP, the poverty rate was more than 20% in 2014. However, all statistics indicate that poverty is declining. China's HDI has continued its slow



growth trend and stood at 0.727 in 2014, which means that China now falls into the class of countries with high human development. The per capita disposable income in urban/rural areas in 2015 totaled CNY 31,195/CNY 11,422 (\$4,533/\$1,660). The urban-rural income gap had declined very slowly to below 3:1, but this does not take into account informal incomes, the variation of living standards across China, and the effect of rapid urbanization. It does also not take into account that poverty has become structurally ingrained, disproportionately affecting rural citizens, and that social groups with close ties to those in power at any level of government are able to monetize their social capital. Traditionally, Chinese women are well-integrated socially and economically. China's Gender Development Index score in the HDI was 0.943 in 2014 and with a value of 0.191, China ranked 40th worldwide in the Gender Inequality Index in 2014. However, discrimination exists in the labor market. The difference in labor force participation was 14.4% in 2014, and the estimated GNI per capita was one-third less for women than men in 2011, the last year covered in the 2015 UNDP Development Report. Women's participation in politics remains severely limited. Only 23.4% of representatives to the National People's Congress are women. They are even fewer in the upper echelons of power: no woman has ever been on the CCP's Politburo Standing Committee, and only two out of 25 members of the Politburo, and 10 out of 205 full members of the Central Committee are female. Of the 171 alternate members, 20 are female. Women acting as provincial party secretaries or governors are extremely rare exceptions. Ethnic minorities are subject to social and economic exclusion and marginalization, with the majority of China's poor living in minority regions. Most prominently in the Muslim Xinjiang Uighur region and the Tibet Autonomous Regions, political marginalization, territorial infiltration and cultural insensitivity by Han Chinese and unequal access to well-paid work often provoke violent resistance and have led to the formation of separatist movements.

Economic indicators		2013	2014	2015	2016
GDP	\$ M	9607224.2	10482371.3	11064664.8	11199145.2
GDP growth	%	7.8	7.3	6.9	6.7
Inflation (CPI)	%	2.6	2.0	1.4	2.0
Unemployment	%	4.5	4.6	4.6	4.6
Foreign direct investment	% of GDP	3.0	2.6	2.2	1.5
Export growth	%	-	-	-	-
Import growth	%	-	-	-	-
Current account balance	\$ M	148203.9	236046.6	304164.4	196380.2

Economic indicators		2013	2014	2015	2016
Public debt	% of GDP	37.0	39.9	41.1	44.3
External debt	\$ M	1471617.8	1770543.0	1325957.1	1429468.0
Total debt service	\$ M	76957.8	81197.1	126418.1	127363.3
Net lending/borrowing	% of GDP	-	-	-	-
Tax revenue	% of GDP	9.9	9.7	-	-
Government consumption	% of GDP	13.5	13.3	14.0	-
Public education spending	% of GDP	-	-	-	-
Public health spending	% of GDP	3.0	3.1	-	-
R&D expenditure	% of GDP	2.0	2.0	2.1	-
Military expenditure	% of GDP	1.9	1.9	1.9	1.9

Sources (as of October 2017): The World Bank, World Development Indicators | International Monetary Fund (IMF), World Economic Outlook | Stockholm International Peace Research Institute (SIPRI), Military Expenditure Database.

7 | Organization of the Market and Competition

Competition in China is market-based, but the playing field is not level. China's private enterprises dominate the economy: in 2013, they generated more than half of China's GDP. However, most private enterprises are very small and find it difficult to obtain access to markets and capital. These conditions are not uniform across China. Where the private sector dominates, for example in the Pearl River Delta, production chains facilitate independence from state actors. Sectors and areas with strong state involvement are often a difficult environment for private firms. Several of the most successful private enterprises, for example in the high-tech and telecommunications sectors, have their origin in government institutions and were founded by former officials or people with good connections to the government. The legal framework for private business continues to be weak, opaque and arbitrarily implemented. The anti-crisis stimulus measures of the Chinese government since 2008 have mostly propped up big state-owned enterprises (SOE) to the detriment of private businesses. Since the outbreak of the financial crisis, private enterprises have found it even more difficult to access bank credit, even though there is plenty available cash in the market; loans primarily have flowed from state banks to SOEs. This has facilitated the continued growth of China's shadow banking sector, where private enterprises can obtain funds through peer-to-peer lending or entrusted loans. While the size of the shadow banking sector had been negligible before the 2007-2008 global financial crisis, it equaled 80% of China's GDP in 2015 according to

Market-based competition

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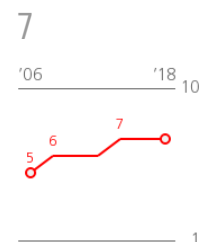


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Moody's Investors Service. Estimates by other organizations, for example the IMF, are lower (35% of China's 2014 GDP). Foreign business investments remain subject to government restrictions, yet these restrictions are gradually being repealed. In 2015 and 2016, the number of restricted sectors for foreign investment was reduced from 79 to 38, and the number of sectors where they are only allowed a minority share from 44 to 35. Investments in financial companies, highway passenger transport services, ocean shipping tally companies, credit investigation and rating services was made easier and several restrictions in the manufacturing, mining and oil and gas industries were lifted. For the first time, foreign equity in e-commerce companies can exceed 50%, but foreign companies are restricted from investing in internet publishing services and can only have minority shares in TV and radio ratings survey companies. Repatriation of profits is difficult due to foreign exchange controls and extensive approval and implementation procedures. In September 2013, the government established the Shanghai Free-Trade Zone (SFTZ), where commodities can be imported tax-free and foreign investments are permitted in all but 16 sectors. The SFTZ, which was expanded in 2015 to include Free-Trade Zones in Guangdong, Fujian and Tianjin, is also seen as a test lab for full yuan convertibility. Capital account settlements have indeed been made easier than in the rest of China, but full convertibility is still limited and tied to several requirements, because the government fears that an uncontrolled outflow of RMB could negatively affect macroeconomic stability. In contrast, Hong Kong residents can exchange an unlimited amount of yuan since November 2014 in an attempt to facilitate trading between stock exchanges in Hong Kong and Shanghai. Since 1996, the urban informal sector has been growing rapidly. In 2008, it constituted 60% of China's urban economy and was responsible for 28.8% of China's GDP.

In August 2008, a new anti-monopoly law went into force. It prohibits monopoly agreements between competitors, the abuse of dominant market positions and administrative monopolies. It also aims to tear down artificial trade barriers within China to eliminate local protectionism. The Ministry of Commerce (MOFCOM), National Development and Reform Commission (NDRC) and State Administration for Industry and Commerce (SAIC) are responsible for implementing the law. In February 2014, MOFCOM published provisional regulations for simplified merger control that are similar to EU standards before their reform in January 2014. By the third quarter of 2013, 672 mergers had been cleared unconditionally, and only one merger was blocked. By 2014, 33 foreign companies had been investigated by China's antitrust authorities, with tech companies (e.g. Microsoft, Qualcomm) and car manufacturers (e.g. BMW) among the prominent targets. Regulators reject accusations of unfairly targeting foreign enterprises, pointing out that 90% of the 335 companies investigated by the NDRC were Chinese companies. In some strategic sectors (defense, energy production, petroleum, gas, petrochemicals, coal, civil aviation, shipping), the state upholds the existing monopolies of state-owned enterprises, with the partial exception of the Shanghai Free-Trade Zone, where

Anti-monopoly
policy

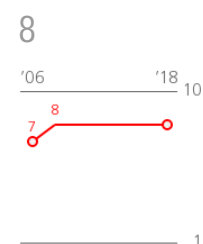


limited investments in shipping and transportation are possible. In 2016, the NDRC focused on the investigation of price fixing in the pharmaceutical sector. This comes one year after the Chinese government lifted price controls that had affected most drugs. That same year, SAIC had completed a five-year investigation of Tetra Pak, which was fined CNY 667.7 million (\$97 million) for abusing its dominant position in China's market.

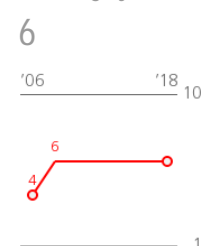
Since the global financial crisis, China has become somewhat less dependent on foreign trade. While in 2006 exports equaled 36% of China's GDP, the respective figure for 2015 was only 22.6%. Similarly, imports declined from 31% to 15.2%. However, the export of manufactured products, a large number of which are assembled from imported parts, still plays an important role in the Chinese economy, and in 2012 China surpassed the United States as the world's largest trading nation (merchandise trade, excluding services). Since accession to the WTO in 2001, foreign trade has been continually liberalized; direct intervention in trade decreased, import barriers have been reduced and the average most-favored-nation tariff rate was 9.5% in 2015. Many machinery and material inputs required for manufacturing are tariff-exempt, especially for enterprises operating in the 113 "Comprehensive Bonded Zones" (known as "Special Customs Supervision Zones" before 2014). China entered into bilateral free-trade agreements with Australia and the Republic of Korea, and was in the process of negotiating a Regional Comprehensive Economic Partnership with Association of Southeast Asian Nations (ASEAN) and Japan, Korea, Australia, New Zealand and India as well as a China-Gulf Cooperation Council Free-Trade Agreement. The sixth WTO Trade Policy Review for China, issued in July 2016, notes that China has been reforming custom procedures to facilitate imports and exports and has reduced the number of anti-dumping measures from 113 to 91. Most of these measures affect the United States and Japan. In addition, the protection of intellectual property rights has improved.

Important banking sector reforms were announced in the review period, but assessments by domestic and international observers and experts regarding the quality and strength of banking supervision remain mixed and contradictory, in part because of the lack of reliable first-hand information. Since 2016, banks have been able to set higher and more market-oriented interest rates on deposits; local governments are now allowed to issue bonds; and a deposit insurance system has been implemented. These measures are aimed at mitigating the considerable risks caused by a fast-growing shadow banking system. At first glance, China's banking system appears solid. In 2015, 66.3% of China's banking assets were held by five state-owned commercial banks while joint stock commercial banks accounted for another 27.6%. The remaining shares of total assets are held by 144 city commercial banks (6.1%). In late 2016, the Bank for International Settlements warned that at 30.1, China's credit-to-GDP was very high, signaling a high risk of financial overheating in the near future. A level of 10 is considered the threshold from healthy to unhealthy. At the same time, the non-performing loan ratio of urban commercial banks increased

Liberalization of foreign trade



Banking system

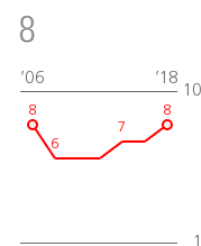


from less than 1% in 2013 to more than 1.5% in 2015; that of rural commercial banks from 1.75% (2013) to 2.5% (2015). The four biggest state-owned commercial banks (SOCB) are listed on stock exchanges and belong to the world's biggest banks with regard to market capitalization. This has brought not only fresh capital to the system at large, but also foreign accounting groups now review the banks' financial reports, which has resulted in greater transparency. According to WTO commitments, much of the banking sector has been opened to foreign banks and restrictions on foreign banks' local currency businesses have been lifted, but the market share of foreign banks remains small. Privatization in the financial sector is not far advanced; most non-bank financial institutions, such as life insurance, investment, and securities companies, are state-owned or controlled by local governments. However, this excellent performance can partly be explained by the fact that high-risk lending occurs outside the formal banking system. Stimulus measures by the Chinese government during the global financial crisis led to a relaxation of the rules on informal lending, and trust companies, small lending companies and informal lenders have captured increasing shares of the financial market. Different estimates put the increase in off-balance sheet lending from 5.5% in 2006 to between more than one-third and 80% of GDP in 2015. Commercial banks are connected to the shadow banking system. They short-sell wealth management products to finance the high-risk operations of trust companies and are required to lend money to local government financing vehicles. According to the president of the People's Bank of China, 20% of these vehicles were unprofitable. In addition to issuing bonds, a number of local governments have resorted to tapping the informal financial system to roll over their loans. Land and real estate serve as the main collateral, making China's financial system extremely sensitive to real estate bubbles. The lack of information on the true size of the shadow banking system, its various connections with China's commercial banks and the linkages with citizens' deposits and mortgages makes it difficult to estimate the overall impact of a default of informal loans on China's financial system. As a remedy, the central government has increased rates for interbank lending and announced the reforms described above.

8 | Currency and Price Stability

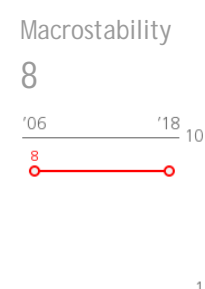
China's inflation rate remained low and stable during the review period. After fluctuations of the consumer price index between -0.7% (2008-2009) and 5.4% (2010-2011), consumer prices increased 2.06% between 2013 and 2014, 1.4% between 2014 and 2015, and 2.1% between 2015 and 2016. In 2015, imports and exports both fell, the latter more dramatically than the former: imports decreased by 2% between 2014 and 2015, exports by nearly 14% . However, FDI in 2015 increased 6.4% , which is a significantly higher growth rate than in the previous year (1.7%). Despite this, China's foreign currency reserves decreased rapidly in the review period, from a peak of $\$4,000$ trillion in early 2015 to $\$3,000$ trillion at the end of 2016. The sale of dollars is the consequence of the central bank's attempt to support

Anti-inflation /
forex policy



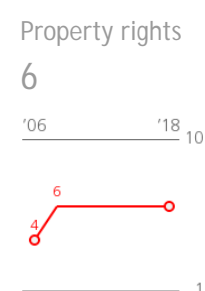
the yuan against an appreciating dollar. China has a managed exchange rate. In March 2014, the daily trading band for the Chinese yuan against the dollar was increased from 1% to 2%. With the Chinese yuan rather closely following the appreciating dollar over the review period, Chinese exports lost competitiveness when compared to other East Asian trading nations. The Chinese central bank is not independent, but under tight oversight by the central government, which sees the financial system as an important instrument for macroeconomic control.

Macroeconomic stability is of utmost importance to the Chinese government. Thus, it is not surprising that the Chinese government has continued to stimulate the economy throughout the review period. Benchmark lending rates and required reserve ratios were lowered, government spending increased and property purchase regulations were relaxed. GDP growth further dwindled from 7.4% (2013-2014) to 6.5% (2014-2015). However, the government's pro-growth fiscal and monetary measures only reinforced the structural problems of the economy, which is overly dependent on fixed asset investment (50% of GDP) and real estate investment (accounting alone for about 13% of GDP). This combines with higher debt levels than in previous years, a higher ratio of non-performing loan ratio and the growth of the shadow banking sector to feed into what many observers see as a growing economic bubble. The basic challenge for Chinese authorities is still the same: to maintain annual growth at a high enough rate to guarantee an adequate number of jobs while at the same time rebalancing the economy toward a more sustainable consumer-driven development path in order to avoid what is called the "middle income trap" (a lack of competitiveness with regard to low income countries and high industrialized countries).



9 | Private Property

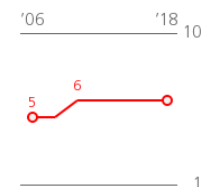
In October 2007, China's first private property rights law came into force. The law "protects the lawful property of individuals," state-owned assets and prohibits the illegal possession, destruction or looting of state property by private persons. However, the implementation and enforcement of these formal regulations is inconsistent and arbitrary, due to a weak judiciary and to corruption in administrative agencies. All land ownership still remains with the state; this means there are no secure property rights for peasants. To address the problem of forced resettlement caused by large-scale governmental construction projects or illegal land grabs by local authorities, the Chinese government in early 2013 promised to better protect land use rights, increase compensation to farmers, even allowing the latter to directly negotiate the sale of rural construction land. This rule also gives farmers the possibility to merge plots and employ modern farming technologies on larger fields, thereby increasing productivity and income. The long-term aim is to push urbanization and pool rural land for large-scale farming by agricultural enterprises.



China's private enterprises dominate the economy; in 2015 they generated more than half of China's GDP. However, most private enterprises are very small and find it difficult to obtain access to markets and capital despite the fact that periodically, the central government announces its intent to strengthen small and medium private enterprises. For example, the latest five-year plan (2016-2021) promotes "creativity of the masses" and encourages individuals to engage in private business. The environment for private enterprises varies across China. Where the private sector dominates, for example in the Pearl River Delta, production chains facilitate independence from state actors. Sectors and areas with strong state involvement are often a difficult environment for private firms. Several of the most successful private enterprises, for example in the high-tech and telecommunications sectors, originate in government institutions and were founded by former officials or those with good connections to the government. The legal framework for private business continues to be weak, opaque and arbitrarily implemented. However, due to murky ownership structures, hidden subsidies and various statistical indicators, it is nearly impossible to draw an exact line between what is referred to in China as the "public" and "non-public" sectors. In November 2014, there were 15.2 million private enterprises and 49.5 million individually owned businesses, which altogether employed 246 million people. 90% of these companies are in the service sector, 8% in industry, and 2% in agriculture. In the 2012 industrial sector, private enterprises made up 55% of all enterprises with a revenue over 20 million yuan and were responsible for 33% of all profits. The boundaries between SOEs and private enterprises are set to become even murkier. In the review period, yet another initiative was launched to reform China's state-owned enterprises. Termed "mixed ownership", the policy encourages SOEs to become shareholder companies and make use of other financial instruments. However, the majority of shares will remain in the hands of the government. At the same time, ownership and management are to be separated. Hence, privatization will only be partial, mirroring the competition between statist and liberal ideologies in China's government. In recent years, big private enterprises have dominated online retail in China and have become important players in cross-border acquisitions. Although private enterprises also benefit from the private property rights law, some stumbling blocks remain, such as difficult access to capital, licensing procedures hampered by long delays and a lack of transparency, local government favoritism and pressure to pay illegal fees.

Private enterprise

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10 | Welfare Regime

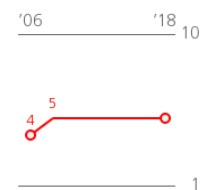
Basic public social security systems covering pensions, health care, unemployment, accidents and maternal care are in place in China and have been gradually extended from the urban to the rural population while a rapidly increasing number of rural poor can now claim social benefits. However, as family farmers are not considered employed, unemployment insurance still only covers employees of urban enterprises and institutional organizations. Furthermore, entitlements depend to a significant

Social safety nets

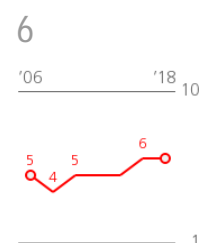
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degree on the size of contributions, meaning that those with low incomes receive only very basic and limited services. Another serious problem is social security benefits for migrant workers, as many employers do not pay the necessary premiums, even though the law obliges to do so. In addition, although the Social Insurance Law in effect since 2011 mandates the transferability of earned social insurance benefits, it faces severe challenges in practice. Likewise, the large number of Chinese employed in the informal sector suffers from inadequate coverage for social risks. China's urbanization regulations, which were unveiled in 2013 and 2014, stress that the rights and social integration of migrant workers must be improved. Finally, urban and rural social security systems are to be integrated, with the ultimate aim of abolishing discrimination against those with rural household registrations. According to the National Bureau of Statistics, by the end of 2015, 858 million people were enrolled in a basic pension system, 666 million people participated in basic health insurance program, 173 million people participated in unemployment insurance programs, and 214 million people participated in work accident insurance. Minimum living allowances were granted to 17 million urban residents and 49 million rural residents. Five million rural residents received social welfare benefits in the form of the so-called Five Guarantees scheme, a subsidy for people who have no legal support, are unable to work and have no income (e.g., seniors, the handicapped, or adolescents under 16 years of age). For these groups, the government subsidizes food, clothes, medicine, housing and the cost of burial. Since hospitals and doctors often charge arbitrary fees or insist on bribes for service, there is a high degree of uncertainty as to which costs for health care and other risks might be expected in the future. For example, the system is not designed to treat expensive chronic diseases, and the poor can often not afford to pay the patient's contribution, which excludes them from medical insurance benefits. Corruption and mismanagement in the health sector leads to many protests, at times turning violent.

Facilities for education, social security and public services are developed in urban coastal regions and are steadily improving in the rest of the country. However, the quality of services individuals receive depends on income. China's male-to-female ratio at birth is 1.18 and mirrors the preference of Chinese parents for their first child to be male. Though forbidden, many parents use prenatal diagnostics to determine the sex of their child, and female fetuses are sometimes aborted. Owing to historical factors, there remains a 5.1% gender gap in adult literacy (2015), but literacy rates for those aged 15 to 24 are virtually identical (99.6% female, 99.7% male). In terms of gender (but not wealth), China is one of the most equal countries in Asia in terms of access to education. Female enrollment rates are equal to male enrollment rates in primary and secondary, and higher in tertiary education (1.2). However, females are disadvantaged both in access to jobs and salaries. In 2014, women made up 43.9% of the labor force, the difference in labor force participation was 14.4% and GNI per capita was one-third less for women than for men in 2011. This marks an overall worsening of the situation: in 1990, women earned almost 80% of men's salaries.



Equal opportunity

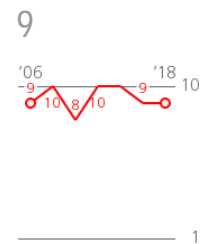


Migrant workers and their children are still disadvantaged, but the Xi Jinping administration is showing commitment to fully integrate migrants into society. The measures proposed in 2013 and 2014 include integration into social security systems, social integration and access to education. This comes on the heels of the closure of several Beijing schools for migrant children. Especially among the older generation, and in particular in the rural areas, women are not regarded as equals, but the situation is changing for younger generations. Regarding political participation, women held 23.4% of the National People's Congress seats in 2013, but are all but excluded from any organization with decision-making powers. Economic exclusion of and social discrimination against ethnic, religious and linguistic minorities in mainstream society continue.

11 | Economic Performance

Macroeconomic performance in China continued to be rather high compared with other major (emerging) countries, but was lower than in the past. Growth rates dropped from 9% to 12% to under 7% in the review period, which has been announced as “the new normal” and results from a slow change of the growth model. GDP grew 7.4% in 2014, but only 6.5% in 2015. At 1.4% in 2015 and 2.1% in 2016, inflation was low. GNI per capita at market exchange rates was \$7,930 in 2015 (ranking China in the lower half of countries as listed by the World Bank). The official rate for urban unemployment was 4% (end of 2016), but most observers estimate total unemployment at around 14%. In 2015, government revenue increased 5.8% to CNY 15.2 trillion; total government expenditure amounted to CNY 17.6 trillion, an increase of 13.2%; according to the International Monetary Fund, gross government debt stood at 42.9% of GDP in 2015, but is probably much higher as some loans by local governments and state-owned enterprises count as private debt. According to a report by the Financial Times, combined public and private debt in China had risen to a record high of 237% of GDP in the first quarter of 2016. Imports and exports totaled \$3.953 trillion in 2015 and China registered a trade surplus of \$593.1 billion (+55.04%). Realized incoming FDI was \$126.2 billion (+5.48%) while outbound non-financial FDI was projected at more than \$170 billion in 2016, marking a year-on-year increase of 53.3% in August 2016.

Output strength



12 | Sustainability

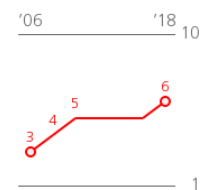
In 2015, China emitted 10.07 billion tons of carbon dioxide, the highest total worldwide (almost 30% of global total CO₂). On a per capita basis, however, China's emissions are significantly below those of developed countries in Asia, and 1/3 of those in the U.S. Still, in November 2014, the U.S. and China agreed to cut CO₂ emissions. China promised to cap its emissions by 2030, and the U.S. pledged to reduce emissions to a figure 28% below its 2005 levels by 2025. In 2015, China's

Environmental policy

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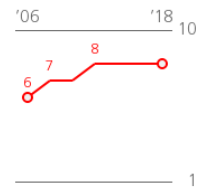
CO2 emissions decreased by about 0.7%, signaling that China takes its pledge seriously. Even though the Trump administration is renegeing on its obligations, it is likely that China, where higher energy efficiency is crucial for the sustained growth of its economy, will continue to improve its ecological footprint, as it has done in the review period. Of great concern to the Chinese authorities are air and water quality. Since 2008, when PM2.5 levels began being regularly measured, Beijing's air has been "unhealthy" nearly half of the time, "very unhealthy" 15% of the time and "hazardous" nearly 5% of the time. However, according to a study by researchers at Peking University, air quality improved somewhat between 2013 and 2015 in the five major cities studied. They attributed the improvement to a combination of stricter emissions regulations and a slowing economy. Water pollution is another serious problem. According to a report by Xinhua News Agency, only 3% of urban groundwater is fit for drinking. Overall, over 80% of the groundwater in China's heavily populated plains is not fit for drinking or bathing, according to Chinese statistics cited by the New York Times. As pollution is responsible for some premature deaths, it has become a major public concern and is a bottleneck for China's continued development; environmental protection is high on the CCP's agenda and addressed prominently in the five-year plans. Coal power plants supply most of China's energy, and as China's coal is high in sulfur, coal firing greatly contributes to air pollution. In 2016, the contribution of coal power plants to China's energy mix decreased by 3.7% to the benefit of water, wind and nuclear energy. In addition, inefficient power plants are being closed. As a short-term measure, nearly six million cars that did not meet emission standards were pulled off China's roads in 2015. In 2005, the Chinese authorities announced that energy efficiency would be improved; GDP per unit of energy use (kg of oil equivalent) has increased from \$2.0 (constant 2011 PPP \$) in 1990 to \$5.4 (constant 2011 PPP \$) in 2015. Finally, in April 2014, the environmental protection law was amended for the first time in 25 years, removing limits on fines for polluters. The Environmental Performance Index 2016 (EPI), which ranks how well countries perform on protection of human health from environmental harm and ecosystems, ranks China 109 out of 180 countries, a clear improvement compared to its 2014 rank of 118 out of 178 countries. The problem, however, is implementation, because the incentives for local governments to allow factories to cut production costs by polluting the environment is high while the risk of detection low. In terms of government promotion, GDP growth and investment appeal are still higher priorities than environmental protection.

China's research and technology sector is rather advanced and continues to improve: spending on R&D as a percentage of GDP has risen from 0.6% (1995) to 2.1% (2015), overtaking Europe in terms of R&D intensity. R&D is heavily driven by foreign companies' investments, and is dispersed unevenly across the country. Chinese patent offices receive more applications than were received in any other country. However, against 1.9 million patent applications in China stand a total of 1.897 "triadic" patents (patents filed in USA, Japan and Europe) granted to Chinese



Education policy /
R&D
8

innovators in 2013. It must be noted, however, that domestic invention patents and international triadic patents are very unevenly distributed, with a handful of international enterprises such as Huawei and Lenovo being responsible for most of these patents. In addition, almost one-third of all successful patent applications in China were filed by foreign actors. Still, the number of domestic invention patent applications has increased rapidly since 2005 to 968,251 in 2015. Since invention patents take up to three years to be granted, a steep increase in granted invention patents by Chinese firms is likely in coming years. Between 2014 and 2015 alone, the number of granted domestic innovation patents increased by more than one-third, from 162,680 to 263,436 (2015). Expenditure on education accounted for 4.8% of GDP in 2014, indicating a rising trend and meeting the target outlined in the “Medium and Long-term National Educational Reform and Development Plan (2010 – 2020).” Since previous funding has been distributed unevenly across regions and institutions, favoring urban and coastal regions as well as tertiary institutions, the government is now focusing on rural areas. Unsurprisingly, given the size and heterogeneity of the country and its various provinces and regions, the quality of the education systems remains somewhat uneven. Highly competitive, world-class institutions exist alongside low-quality segments of the educational system. Overall, however, national and province-level education policies ensure a nationwide system of solid education and training.

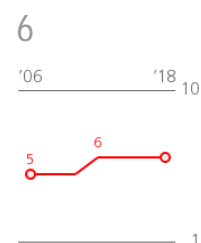


Governance

I. Level of Difficulty

China's political leaders face several structural constraints, some natural, others man-made. Droughts, floods and earthquakes occur regularly in China and not only cause thousands of deaths every year, but also impede China from achieving its goal of food autarky. Furthermore, environmental degradation and water scarcity increasingly constrain the country's development. China's size, combined with uneven development and underdeveloped regional markets, pose great challenges to landlocked and mountainous provinces in central and western China. Severe income inequality strains not only social stability, but also domestic consumption, thereby limiting the competition needed for innovation. Pollution is another limiting factor. Studies suggest that pollution is reducing the life expectancy of those affected and is making (clean) water a scarce resource. This is relevant not only for China's cities, but also agriculture in the countryside. After profiting from three decades of "demographic dividends" from a large working-age population, the share of retired persons is increasing. As a result of its one-child policy, in 2012 for the first time China's working-age population (between 15 and 59 years old) shrank, albeit it only by 3.45 million out of almost 940 million people. China is the first country where the "demographic window," a beneficial relation between the working- and non-working-age populations, will close while the country is still in a developmental stage. The one-child policy was further relaxed in the review period, but has thus far failed to trigger higher birth rates. With wages increasing substantially (often up to 40% per year), not least due to mass demonstrations, an increasing number of foreign and Chinese companies are leaving China to relocate manufacturing centers in "cheaper" countries, such as Indonesia, Vietnam, India and countries in Africa. The CCP leadership seeks to address this problem by strengthening domestic consumption, encouraging "indigenous innovation" and investing in "smart factories", where processes are fully automated and machines communicate with each other through the internet. However, major challenges are posed by the facts that most Chinese cannot afford high-quality products, most enterprises have narrow profit margins and do not invest in R&D and property rights protection remains lax.

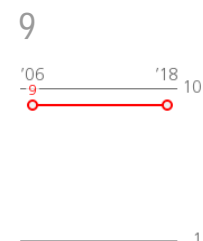
Structural
constraints



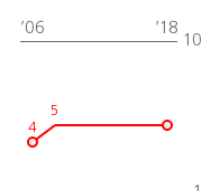
China lacks a robust tradition of civil society, not least because Chinese society is group-centered. Nevertheless, the number of officially registered social organizations and NGOs has steadily increased from 153,222 in 2000 to 662,425 in 2015, employing more than seven million people. Official registration entails finding a government unit to act as a guarantor and fulfilling a number of other requirements that serve to keep a check on social sector growth. However, the number of small and unregistered organizations is estimated to run into the millions. The government is faced with the quandary of needing social participation to enhance the provision of public service while fearing that these organizations may challenge its power. Hence, registered NGOs and non-registered voluntary organizations are only partially able to provide channels for popular participation or representation of social interests. The government's recent exhortations for philanthropic donations are largely ignored.

While there are no irreconcilable ethnic, social or religious cleavages in China, social unrest is commonplace. However, most demonstrations of dissatisfaction with the government policy are small – comprising only a dozen or so people – but are concerned with existential issues like wage arrears, the demolition of houses and the relocation or expropriation of rural land. Although not as frequent, spontaneous and large-scale demonstrations occur almost annually, often in the form of “not in my backyard” protests aimed at polluting factories and waste plants. Economic development has proceeded in a highly unequal manner, as indicated by widening wealth gaps and unequal access to health care, secondary and higher education, and contributes to the fragmentation of society into a small, affluent group and a large, economically underprivileged group. According to the Hong Kong-based China Labor Bulletin, there were 2,774 strikes in 2015, double the number of incidents for 2014. Occasionally, conflicts with the police or other state organs lead to outbursts of mass vandalism. Relations between Han Chinese and ethnic minorities (in particular Tibetan and Uyghur) remain tense; control is maintained through a massive, visible police presence in strategic locations. In Beijing's center, police with anti-riot gear are stationed at strategic points 24 hours a day, and visitors to Tiananmen Square are subjected to thorough security controls.

Civil society traditions



Conflict intensity



II. Governance Performance

14 | Steering Capability

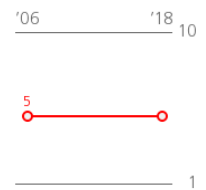
The Chinese government pursues social stability and economic development as its two main priorities. In contrast, a transformation toward democracy based on the rule of law is not one of the government's long-term strategic aims. Rather, the government follows a deliberate strategy of counterbalancing the threat of pro-

Question
Score

Prioritization
5

democracy tendencies and challenges to the party's political hegemony. Policy-making is characterized by long-term perspectives and subject to evidence-based impact assessment and strategic planning. The government uses guidelines to provide a framework for binding and non-binding policy objectives. Five-year plans specify social and economic targets, some of which are quantified and binding while others are non-quantified and highlight results that local governments should try to achieve. Major policy changes – like those involving innovation or education – take longer to achieve, so the timeframe is extended to 10 or even 15 years. At the local level, targets are tackled in incrementally by formulating annual plans. These plans have thus far been consistent; yet, while crises might delay the achievement of targets, no five-year plan has been abandoned. Overall capacity is weakened by both the de facto hierarchization of departments and implementation gaps between envisioned and actual outcomes. Departments concerned with economic development usually take precedence over those with social or environmental portfolios. Local governments are given several abstract achievement targets, the fulfillment of which often depends on their priorities, capabilities and budgetary means. In the review period, the newly passed five-year plan suggests that the government will continue its effort at economic restructuring. Domestically, the plan foresees measures to reduce overcapacity in industry, most notably in the production of steel and solar panels, but also in the real estate sector. Affordable housing is to be created and the service sector strengthened. The leadership aims at moving China up the supply chain by phasing out low-skill manufacturing and producing high-quality products (“China 2025”), and investing in automation and data exchange between production units (“Industry 4.0”). Urbanization is set to continue, and the government sought to cushion impending labor shortages by abolishing the one-child policy, which in effect is a two-child policy now. These measures tie in with the Silk Road Economic Belt and 21st Century Maritime Silk Road policies, commonly known as “One Belt, One Road” (OBOR). In the review period, this policy became operational, with the government investing \$11 billion in some of the participating countries, most of which are still in the developing stage. Some of these funds are distributed by the newly created Asian Infrastructure Investment Bank, others by policy banks such as the Import Export Bank of China. While these initiatives are developing, a concentration of power has been taking place. In 2016, CCP General Secretary Xi Jinping has been elevated to the status of the “core” of the Party. In addition, he has assumed the chairmanship of an increasing number of specialized commissions, causing observers to mockingly refer to him as CoE (“Chairman of Everything”). This power concentration has come at the cost of a further deterioration of human and political rights and increased levels of repression.

The central government can effectively implement political priorities that it considers binding, but the range and extent of its capacity to do so depends on its resolve and on the interests of local governments. Moreover, the government is not intending to implement political reform measures that might initiate a transformation toward

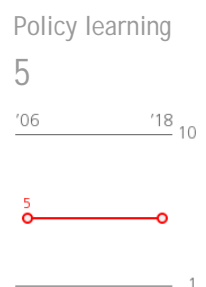
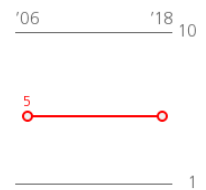


Implementation

5

democracy based on the rule of law. Policy implementation is easiest where interests and priorities converge, economic growth being a prominent example. It is most difficult where the priorities of the central government do not match those of local actors, and where it monitors and sanctions non-compliance weakly or not at all. Implementation of a policy against the will of local governments is possible yet costly, and is usually carried out in the form of campaigns. More important than these issues is the fact that the central government depends on local initiative to govern this continent-sized country with institutions that are highly centralized in form. While compliance is important, and can be ensured, the central authorities depend on local initiative to govern routine affairs and to contextualize development targets. In the review period, the Xi administration's campaign against corruption effectively illustrates this fragile balance. The campaign antagonizes the overwhelming majority of local officials, who have no real power to resist it, and has stymied local initiative. During the review period, the 12th five-year plan (2011-2015) concluded. Nearly all of the objectives were met, which the CCP takes as proof of its implementation capacity. The Chinese economy has continued to grow, and the contribution of the service sector to GDP has increased. The urbanization target was surpassed, and the growth of CO2 emissions is slowing. However, some of these "successes" can be attributed to the sluggish development of China's industry, which contributed to the relative growth of services and lower emissions. In addition, central government stimulus has resulted in an increase in financial risk, higher local debt levels and the continuing formation of local overcapacity in industry and the real estate sector.

The Chinese leadership demonstrates the ability and willingness to learn from past experiences and from new sources of knowledge, albeit in non-systemic form. Experimentation and learning occur locally and on an ad-hoc basis, with academic experts and practitioners consulted only occasionally. While Chinese officials have displayed a great capacity to learn from past experiences, observe and exchange knowledge nationally and internationally, and, to a limited degree, consult experts, these processes are not coordinated and are not in line with international best practices. Policy monitoring is often informal, with individuals being given the responsibility to supervise particular processes or actors, and policy evaluation usually takes place only when a policy is set to be replicated elsewhere. Otherwise, policies that are considered unsuccessful are often discontinued without a systematized reflection about the causes of failure. This flexibility is mainly confined to social and economic policies, but also extends to administrative reforms, which were commonplace at the city and county level during the Hu Jintao era, but have become more restricted under Xi Jinping. Officials and administrators formulate such reforms by learning from past experience and by studying examples at home and abroad. Most notably, participatory elements are applied in lawmaking, the preparation of budgets and the monitoring of officials, oftentimes using the Internet. However, while these reforms improve governance, they should not be confused with a process of democratization within the regime. In recent years, the leadership ranks

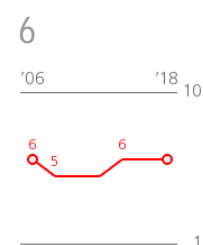


have acknowledged that the past priority on unconfined economic development has brought about social conflict, a highly uneven distribution of wealth, environmental deterioration and an inability for most Chinese enterprises to move up the value chain. Former President Hu Jintao's emphasis on more social equality and justness as well as sustainable development is now part of the party constitution and played an important role in the 12th five-year plan (2011-2015). This trend continues in the 13th five-year plan (2016-2020), which stresses the necessity to strengthen the service sector and improve the ecological footprint of China's industry. These reforms, however, face strong opposition by special interest groups (big state-owned companies and banks) that benefit from unequal access to resources and influential decision-makers, and hamper the implementation of reform measures. The Chinese leadership is not willing to accept that more pluralism and democratic reforms such as media freedom and public participation are required as a safeguard against this sort of undue influence and corruption. Instead, the present Xi Jinping administration seeks to discipline special interest groups by detecting and punishing deviation through the CCP's disciplinary apparatus.

15 | Resource Efficiency

The quality of the civil service has improved; meritocracy through competitive examinations and task-related performance appraisals has been introduced, and the vast majority of civil servants now hold university degrees. E-government and performance monitoring have been widely introduced in China's bureaucracy, and China ranked 63rd in the U.N. E-Government survey 2016, up from rank 78 in 2012. Its E-Government Development Index value was 0.6237, which puts China in the class of countries with a "high" score. Bureaucratic professionalism and efficiency, however, is still undermined by rampant corruption and the overarching power of the CCP, which, through the nomenclature system, influences personnel appointments to upper levels of government and party bureaucracies, putting party loyalty and support for present leaders before professional competence. One reason for corruption is low salaries. In January 2015, civil servants received the first pay raise in 9 years. Although the salaries of the lowest-ranked civil servants were doubled, their new monthly income of CNY 1,320 (\$212) is still very low considering the high costs of living in many of China's cities. China's budgetary system is highly decentralized, with local governments responsible for more than 85% of total government expenditures. The central government takes in over half of all revenues then shares that revenue with the provinces at its discretion. Given the lack of transparency and accountability, fiscal resources are distributed not according to a common and equally implemented scheme but are influenced by the respective provincial leader's political weight and negotiating skills. The central government seems to profit from this arrangement: with 3% of GDP, the overall budgetary deficit in 2016 was low when compared with other countries, but the deficit is growing - in 2015, the deficit was only 2.3% of GDP. On the other hand, local government debt, as reported by official

Efficient use of assets

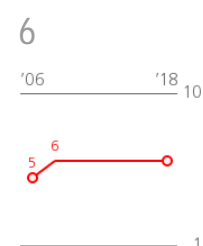


data, was CNY 24.0 trillion (\$3.8 trillion), or 37.7% of GDP, at the end of 2014, nearly half of which came from sources other than bank credits. Most notably, as part of a national experiment, several provinces have begun to issue two kinds of bonds in 2014, one to finance revenue-generating projects such as toll roads, another to raise non-earmarked revenue. This brings the government's debt ratio to a value that is higher than official figures (41.5% in 2015). There is a tendency at the local level to invest in showy projects and create industrial overcapacity, which results in severe misallocation of funds. Due to available funds, this tendency has increased since the financial crisis in 2008-2009 and deepened in 2012.

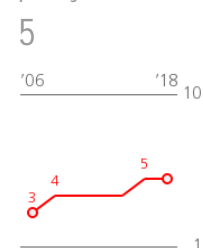
The Chinese government often has difficulty reconciling conflicting policy objectives and interests due to a lack of horizontal and vertical coordination as well as friction between administrations at the national, departmental and regional/local levels. These problems result from differing incentives at the central and the local level, and the different priorities of the various ministries. For example, the central government attempts to prioritize sustainable and equitable growth as well as to curb excessive speculation in real estate, but local governments thwart this policy by fueling excess development in their localities to expand employment opportunities and revenues from which they gain individual political and economic profit. However, priority policies are coordinated in so-called Leading Small Groups, steering bodies that consist of high-level officials from different departments. Two new such bodies to improve coordination have been created under the personal leadership of Xi Jinping: one on national security ("National Security Council"), the other on "Comprehensively Deepening Reform". Crises are tackled by establishing ad-hoc task forces. Although in routine politics, waste resulting from overlapping areas of responsibility and sloppy implementation are considerable, communication channels between the various administrative levels are superb, although this usually only becomes apparent in crises and emergencies when non-conformity results in harsh punishment.

The Xi Jinping administration has initiated the largest anti-corruption campaign since Reform and Opening began in 1978. Targets are officials in the CCP, the government, the military and state-owned companies. Xi announced that this campaign would focus on high-level officials. Former Politburo Standing Committee member Zhou Yongkang, former vice-chairmen of the Military Commission Xu Caihou and Guo Boxing, head of the Central Committee's United Front Work Department Ling Jihua and vice chairman of the Chinese People's Political Consultative Conference Su Rong were investigated for corruption between 2013 and 2015, along with 59 persons with the rank of minister or vice-minister, which includes provincial (vice) party secretaries. By the end of 2016, more than 100,000 people, among which 120 were high-ranking officials, had been indicted or convicted on corruption charges. As corruption in the CCP has been systemic and graft, nepotism, bribery and sale of office widespread, it is unclear how targets are chosen, and whether the campaign represents an attempt to weed out political opponents, improve the foundations of

Policy coordination



Anti-corruption policy



China's development, or both. Apart from systemic political corruption, "petty" corruption – like mandatory payments for better services – is still widespread in Chinese society. However, this has been made somewhat harder with the open government initiative implemented in 2008, which improves access to government information, allows people to request files and enables the payment automatization for taxes, fines and services. Nonetheless, corruption persists, a result of the lack of competitive political processes, institutional checks and balances, accountability mechanisms, an independent judiciary and a free press.

16 | Consensus-Building

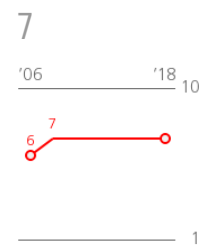
The Chinese government remains strongly committed to preventing the emergence of democratic tendencies; there is consensus among the members of the political leadership and the regime coalition that a transformation toward democracy based on the rule of law must be avoided.

There is broad consensus among Chinese leaders that the continuation of one-party rule, the improvement of living conditions and the defense of national sovereignty and territorial integrity are the country's top goals. Similarly, there is agreement that these goals should be reached through economic development, international integration and the strengthening of China's military force. The Third Plenum of the CCP's 18th Party Congress confirmed that a market economy remains a strategic and long-term goal, and that the CCP wishes to improve governance yet avoid taking steps toward liberal democracy. One Leading Small Group, headed by CCP General Secretary Xi Jinping, has been created to coordinate reforms in the marketization of government services, the structure of SOE, the fiscal system, rural-urban development, citizen consultation and the judiciary, as well as to emphasize the improvement of environmental protection, anti-corruption, Internet control and state security. Although these reforms will not be met with approval by all political actors, their power to veto them is marginal.

Since the late 1980s, the party leadership has been united in their opposition to China becoming a liberal democracy. CCP General Secretary Xi Jinping has pledged to improve the "rule of law" in China, meaning that CCP and government officials will be required to follow formal rules and will be punished for deviation. At the same time, he stresses that the CCP as an organization will remain above the law. An organized opposition to CCP one-party rule does not exist. Any attempt to question the status quo in an organized manner or by visible individuals is met with persecution and long-term imprisonment.

Cleavages exist mainly along ethnic and social lines. Unconstrained competition in unequal markets has caused income and wealth inequality to rise dramatically since the early 1980s, making China one of the most unequal societies in the world. There are serious social distortions and conflict between those segments of the populace

Consensus on goals



Anti-democratic actors



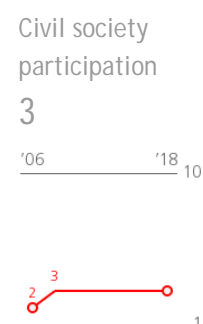
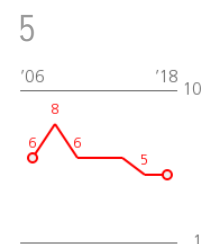
Cleavage / conflict management



with access to education, health care, social security, adequate incomes and living conditions and those without. Violent eruptions of anger by groups of disadvantaged citizens proliferated dramatically and are now commonplace, and one of the CCP's prominent fears is that it may be swept away by a dissatisfied populace. CCP General Secretary Xi Jinping claims to be following the "mass line," a term often associated with Mao Zedong, which raises expectations among the urban and rural poor and serves to widen the existing cleavage. However, increased expenditures for health care and other social services illustrate that the government is seeking to ameliorate these conditions. Furthermore, the government continues to subsidize provinces in western and central China and co-finances poverty alleviation programs in China's poorest counties. Since 2004, income and expenditure differentials between the provinces have been reduced, both because of catch-up development and the central government's redistribution of revenue. The Gini coefficient of provincial revenues and expenditures decreased from 0.47 and 0.35 in 2004 to 0.28 and 0.21 in 2012. Nevertheless, the fact that income and wealth inequality in the general population have not decreased shows that the richest subset of the population in all provinces profits disproportionately from these developments. This is true also for minority provinces and, along with several other factors, is responsible for China's ethnic cleavages. Budgetary transfer payments to Tibet and Xinjiang are disproportionately large, but it is chiefly the rapidly growing Han Chinese population in these provinces that is profiting from infrastructure investments and new economic opportunities. This fact and the CCP central government's lack of respect for the religion and traditions of these people have been major reasons for the rise of separatist movements.

Political decision-making is dominated by internal debates between the CCP and state organs. In recent years, the party and the government have strengthened the integration of expert advice from think tanks and individual academics in formulating policy, and since 2000, the government has tried to strengthen citizen input in policy-making by holding public hearings on pending national legislation. Today, developments of general concern such as health care, education and especially environmental problems and corruption are discussed more broadly in society – not least via the Internet. Nevertheless, even the limited chances for participation and discourse are strongly regulated, monitored and controlled by state and party organs. In case that public debate becomes too explicitly critical of political processes or developments, such debates are suppressed and individuals leading these debates face harassment and even prosecution. Central government regulations state that the general public should participate in the performance evaluation of local officials and administrative departments, but this policy is implemented only selectively.

The Chinese government regularly invokes collective memories of past injustices suffered from Western "imperialism" or Japanese "militarism" to incite national unity and to garner support for its political goals of national development and grandeur. The "Chinese Dream" concocted by the Xi Jinping administration is a recent

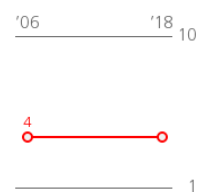


example. Once more, the 19th century Opium War is invoked as the reason why China lost its status as a world power; the Xi administration promises to duly restore this status. The “Chinese Dream” mentality is nationalist in so far as it not only demands a return to “Chinese” values in science, technology and even law, but it also entails the blaming of “Western” powers for trying to intentionally undermine China’s rise. Concerning its own past, the government strictly prohibits all public discourse on human rights violations and does not acknowledge the responsibility of the CCP regime for past injustices, such as the Great Leap Famine, the Cultural Revolution and the Tiananmen massacre.

17 | International Cooperation

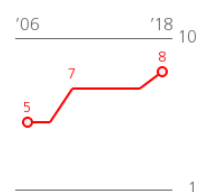
China maintains and expands cooperative ties with multilateral institutions such as the IMF, the World Bank and the Asian Development Bank as well as with foreign governments to obtain support for ongoing economic reforms. In the review period, the Asian Infrastructure Investment Bank, widely perceived as an alternative to the World Bank, began to operate, comprising 50 member countries. In addition, the “New Development Bank”, a new bank by BRICS member countries, went into operation. These initiatives more or less directly challenge the U.S. global (Bretton Woods institutions) and Japanese (ADB) regional leadership roles in economic governance, but the United Nations has expressed that they see these organizations as an opportunity for development, rather than a threat. Some nations, among them Japan and Germany, have cancelled financial assistance to China and concentrate instead on technical cooperation, focusing mainly on the transfer of “green” technologies, sustainable development, health care, social security and legal reforms. China makes efficient use of this support, particularly in areas where it lags technologically, such as in renewable energy sources and energy conservation. However, such assistance is exclusively concerned with social and economic reforms. The government does not allow any international interference with what it terms “internal affairs,” especially concerning democratic reforms, adherence to human rights standards, the solution of the Taiwan and Tibet question (“national unity”).

In recent years, China has increased efforts to be considered a reliable member of the international community and a dependable partner in bilateral relations. This has been mostly true for trade and economic concerns, but also in part for security cooperation. The country’s demand for commodities, capital and consumer goods as well as its role as the hub of Asian transnational production networks has made China a vital trading partner for many countries. Also, China contributes more troops to U.N. peacekeeping missions than the other permanent members of the Security Council, and has stated that it wants to play a greater role in the organization in the future. At the same time, traditional sources of conflict with western countries have persisted, and in some cases even intensified. Although the WTO attests that China has made access to its markets easier and has improved its legal framework, the discourse in



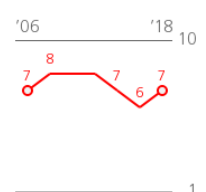
Effective use of support

8



Credibility

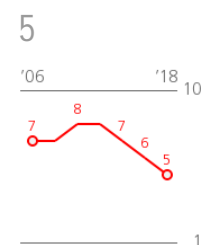
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the United States was significantly influenced by the presidential election, in which candidate Donald Trump accused China of stealing technology and keeping the yuan artificially low to enhance its exports. Cyberattacks traced back to the Chinese government were once more a topic in the review period, and the Obama and Xi Jinping administrations agreed to implement an early warning framework to prevent an escalation. China does not accept the authority of the Permanent Court of Arbitration in The Hague, and its increasingly assertive behavior in regional territorial conflicts continue to raise regional and international concerns as to whether China's self-proclaimed "peaceful development" will persist.

Although trade and investment relations with its Asian neighbors continue to deepen, relations with ASEAN countries (primarily Japan, Vietnam and the Philippines, but also Malaysia and Indonesia) continued to deteriorate. As for the East China Sea, China continued to claim control over the Diaoyu/Senkaku islands and has increased its military presence in the region. China has built warships to protect its vessels, and Chinese fighter planes approached Japanese air space on a daily basis, causing heightened tensions between the two countries. In August 2016, the foreign ministers of China, Japan and Korea met in Tokyo to address this issue, resulting in an understanding that efforts had to be made to resolve the disputes. Tensions also increased in the Spratly archipelago in the South China Sea, where China continued to turn reefs into artificial islands, ostensibly to underscore its territorial claims in the region. Most notably, China started construction work on the Mischief Reef in 2015, increasing the number of artificial Chinese islands in the region to seven. In July 2015, case hearings began at The Hague in the context of an arbitration case filed by the Philippines against China in 2013. On July 12, 2016, the Permanent Court of Arbitration in The Hague ruled in favor of the Philippines, stating that China had no historical rights on the territory. As China does not accept the authority of the court, it did not contribute to the process and rejected the ruling. During the review period, the Xi Jinping administration continued its modernization of the Chinese military (especially its blue water navy and air force), shifting the military balance in Asia clearly in its favor. New weapons have been deployed to increase the territorial reach of China's nuclear and missile forces. With its plan for a Silk Road Economic Belt and a 21 Century Maritime Silk Road China has clearly signaled its intention to use vast infrastructure programs to increase its leverage over neighboring countries.

Regional cooperation



Strategic Outlook

The Chinese government continues to be faced with formidable challenges, including domestic economic slowdown, manifest structural challenges and an uncertain international environment.

The 19th party congress will convene in Fall 2017, paving the way for General Secretary Xi Jinping's second term in office. Five of the seven members of the Politburo's Standing Committee are scheduled for replacement, and the reshuffle will be an important preparation for the change in leadership in 2022. If Xi is serious about increasing the leadership of the Chinese Communist Party, a successor needs to be decided on and nurtured. Given the concentration of power in Xi Jinping, it is difficult to envision how, and indeed if, this will happen. Xi's anti-corruption campaign has probably cost him considerable support among central and local officials, and, even worse, stifled their political initiative. His crackdown on social forces and tight regulation of public discourse is costing the regime potential allies and impedes what before served as an early warning system of expressions of public dissatisfaction with the regime.

In the economic realm, the regime must strike a delicate balance between stimulating growth through proactive credit policy and government investments, and nurturing an economic bubble. The shadow banking sector might pose a risk if it is not further regulated. On the other hand, it also presents an opportunity especially for individual investors and cash-starved private enterprises. Relatedly, the level of national debt should not be allowed to grow further.

An important factor weighing on the above challenges, and being a challenge in itself, is China's foreign policy. Regionally, China needs to reconcile its hunger for resources with the necessity of creating trust among its neighbors. This is especially important as the United States' looming unilateralism is likely to affect the balance of power in the region and introduce political instability. If China can portray itself as a responsible player, it has much to win politically and economically. The same is true for its relations with other actors such as the European Union. If the Chinese government seizes the opportunity to cooperate with others to fill the void created by the United States' likely pullout from Asia and, indeed, world politics, it has an unprecedented chance to participate in the design of a global system built on peaceful relations and sustainable growth. Both would be necessary to ensure China's continued development.