

BTI 2010 | China Country Report

Status Index	1-10	4.79	# 86 of 128	
Democracy	1-10	3.37	# 113 of 128	➔
Market Economy	1-10	6.21	# 49 of 128	➔
Management Index	1-10	5.00	# 63 of 128	

scale: 1 (lowest) to 10 (highest) score rank trend

This report is part of the Transformation Index (BTI) 2010. The BTI is a global ranking of transition processes in which the state of democracy and market economic systems as well as the quality of political management in 128 transformation and developing countries are evaluated.

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Key Indicators

Population	mn.	1318.3	HDI	0.77	GDP p.c.	\$	5383
Pop. growth	% p.a.	0.6	HDI rank of 182	92	Gini Index		41.5
Life expectancy	years	73	UN Education Index	0.85	Poverty ²	%	36.3
Urban population	%	42.2	Gender equality ¹	0.53	Aid per capita	\$	1.1

Sources: UNDP, Human Development Report 2009 | The World Bank, World Development Indicators 2009.

Footnotes: (1) Gender Empowerment Measure (GEM). (2) Percentage of population living on less than \$2 a day.

Executive Summary

During the period of observation, China's economic development progressed at an astounding pace. Economic growth reached 11.9% in 2007, and China became the third-largest trading nation. The People's Republic of China (PRC) hosted the 2008 Olympics and presented China as a self-confident, emerging new power to the international community. Ties with the Association of Southeast Asian Nations (ASEAN) and south Asian nations deepened, underlining China's aspiration to become a genuine regional power. Politically, the Chinese leadership under President Hu Jintao and Premier Wen Jiabao consolidated power during the 17th Party Congress in 2007 and successfully installed close aides and loyal supporters in important party positions, paving the way for a smooth power transfer by 2012. The greatest challenge the Chinese government faces are the repercussions of the global financial crisis which hit China in late 2008. With shrinking demand from the European Union and United States, China's export-oriented economy buckled, and mass layoffs occurred. The government reacted swiftly and provided a 4 trillion yuan stimulus package designed to boost domestic demand and shore up economic growth. Since social stability and the Communist Party's hold on power are closely tied to economic growth, containing the impact of the financial crisis is a question of life or death for the Chinese Communist Party (CCP). Other important problems posing a threat to the country's development and the CCP's hold on power include a still-weak financial sector, rising unemployment and social inequality and the resulting increase in popular unrest, deepening regional developmental disparities, insufficient social security systems, corruption, environmental degradation and a weak regulatory regime to assure product safety. To the great disappointment of the international community, which had put high hopes on the regime's promises of liberalization before and during the Olympics, the human and political rights situation did not improve. Tensions with ethnic minorities, particularly with Tibetans, intensified.

History and Characteristics of Transformation

The “Opening and Reform Policy” initiated economic transformation in 1978. Following the upheaval of the Cultural Revolution, the Chinese leadership instead began to emphasize economic and political consolidation. Despite initial structural deficiencies, economic reforms benefited from preconditions seldom found in developing countries; the large size of the rural workforce facilitated the recruitment of cheap labor for the emerging industrial sector, and despite the existence of a planned economy, the public sector remained rather limited. These specific circumstances considerably facilitated economic development.

Consensus within the Chinese leadership to be resolute in following the Opening and Reform policy facilitated reforms. However, the leadership also agreed upon limiting the reforms strictly to the economic area; political reforms and liberalization were rejected.

Economic reforms proceeded gradually and experimentally. Working without a detailed roadmap, the Chinese leadership allowed reform initiatives from lower administrative levels to be implemented locally on a trial basis. Successful initiatives were adopted as national policies.

Economic reforms proceeded in a highly decentralized manner and allowed for gradual changes, avoiding the transformation shocks that were observed in the Russian Federation. Most important for the maintenance of economic stability was the Chinese leadership’s decision to allow for the coexistence of a planned economy and the gradually emerging private sector. During the reform process, the de facto economic importance as well as political appreciation of the private sector increased steadily. In March 2004, the latest revision to the Chinese Constitution protected private property and acknowledged the importance of the private sector in the national economy.

Economic reforms were accompanied by yearly growth rates averaging 9.8% (1978 – 2007) and relatively low levels of inflation. Living standards improved significantly; the number of the absolute poor decreased from 250 million (1978) to 14.8 million (2007) individuals. This overall success is beclouded by the increasingly uneven spread of wealth, however. Urban incomes are 3.2 times those of rural incomes and the top 10% of urban Chinese earn 9.2 times as much as the bottom tenth (in rural areas, the top 10% earns 7.3 times more than the bottom strata); per capita GDP of the country’s wealthiest province is 9.9 times that of the poorest. Corruption, an inefficient legal system, government agencies unable to properly implement laws and regulations in accordance with WTO requirements, and a lack of sustainability in economic development constitute other serious problems. Environmental degradation will result in particularly critical future economic and social costs, and thus burden further development. Inadequate social security, health care and pension systems also give rise to concern. China is increasingly unable to fulfill the demands of the growing middle class for education, suitable employment opportunities and political pluralism. All of this has resulted in a continuing erosion of the

legitimacy of the ruling Chinese Communist Party (CCP), and a dramatic increase in social unrest as people without access to institutionalized channels for criticism resort to riots and violent clashes with authorities in order to air their grievances. The country's current leadership, headed by President Hu Jintao, confirmed in office in October 2007, is determined to no longer concentrate exclusively on economic growth, but also to take the often-negative social consequences of economic development into consideration. President Hu pleaded for and succeeded in enshrining his concept of "scientific development" into the party constitution in 2007. Contrary to China's promises in the run-up to the Olympics, this event did not bring about any improvements in the areas of human rights, rule of law or democratization. As the global financial crisis hit China in late 2008, the export-driven economy slowed down remarkably. Means of stimulating national consumption had to be found in order to avoid rising unemployment and social unrest which could threaten stability and the Party's hold on power.

Transformation Status

I. Democracy

1 | Stateness

China's sense of statehood is very certain, as there is virtually no competition with the state's monopoly on the use of force. With the important exception of Taiwan, which is regarded as a "renegade province," and of continuing secessionist activities in the Xinjiang and Tibet Autonomous Regions, there is basic agreement about which people qualify as Chinese citizens.

Monopoly on the use of force

According to the Chinese Constitution, China is a unitary, multinational state. Most citizens seem to accept and support the People's Republic of China (PRC) as a legitimate sovereign nation state. All citizens are guaranteed basic civil rights. Minority rights in self-governance and representation, economic autonomy, educational autonomy, religious freedom, cultural expression, language use, and freedom from discrimination are guaranteed by law; nevertheless, the implementation of the law is uneven. Ethnic Tibetans in particular have become increasingly frustrated with their lack of effective political and cultural autonomy and equal opportunities in economic life. Their demands for autonomy have intensified and clashes with members of the Han majority in the region have increased in pace, culminating in violent riots in March 2008. However, the more assertive the Tibetans and other minority nationalities such as Uighurs become, the more they are subject to repression.

State identity

China is officially an atheist state; religious dogmas have no influence on politics or the law. Only five religions – Protestantism, Catholicism, Buddhism, Taoism and Islam – are officially recognized, and all are strictly controlled. However, as economic reforms have eroded communist ideology and traditional Chinese family values, people have increasingly turned toward spiritual ideas. Thus, all kinds of religions, including folk religions and ancestor worship, have begun attracting more adherents. According to one recent survey, 23% of the population (or about 300 million people) identified themselves as religious believers. The government is tolerant of the revival of these various forms of religion, in the belief that it will foster greater social cohesion. More recently, the government has even promoted Buddhism and Taoism as integral parts of Chinese culture.

No interference of religious dogmas

In the PRC a fundamental and sufficiently differentiated bureaucratic structure extends to the entire territory. However, conflicts among different layers of the administration persist, and in some cases have worsened. In particular, it has become more difficult for the central government to ensure that national policies are implemented correctly by lower administrative levels.

Basic
administration

2 | Political Participation

Under Chinese election law, people's congresses under the county level (i.e., at the township level in the countryside, or municipality or district levels in urban areas) are to be directly elected. Although the nomination of candidates, voter eligibility and the electoral process itself are mostly subject to local government and party control and manipulation, some self-nominated or write-in candidates actually have been elected in recent years. In some places, party secretaries at the township level are also chosen by to popular election, suggesting that the electoral process at the lower levels has been marginally opened as a way to deal with increasing public discontent over corruption. In general, the electoral system is an indirect, multi-tiered system controlled by the CCP, but at each level, there are more candidates than seats, and party favorites do wind up being voted out of the delegation. The most significant recent development was the mid-2008 introduction of multicandidate elections for party secretary and mayor in Shenzhen, a city in southern China with a population of 10 million.

Free and fair
elections

Even though the National People's Congress (NPC) is the highest legislative body of the state, the CCP effectively controls its composition and its agenda. Government officials at the national, provincial and county levels are not democratically elected. Decisions on appointments and promotions throughout the political system are controlled by the politburo with the help of the Organization Department of the CCP. With the appointment of his old friend Li Yuanchao as the head of the Organization Department on the eve of the 17th Party Congress, Hu Jintao's control over the Party appointment process was strengthened. Other personnel changes in the 17th Party Congress all suggested a further consolidation of power by Hu, who serves both as state president and party secretary-general, and will influence the succession process due in 2012.

Effective power to
govern

The freedoms of association and assembly are ostensibly ensured by the constitution, and the PRC officially describes itself as a multiparty cooperative system, with the CCP supervising eight other so-called democratic political parties. However, the state often interferes with such rights. The number of registered civil society organizations in China has increased from 154,000 in 2000 to 387,000 in 2007, but these organizations are not allowed to operate independently; the state requires them to register with the relevant state agencies and places them under tight supervision. Political organizations competing with the CCP, including

Association /
assembly rights

“opposition parties” such as the China Democratic Party, are suppressed. In the lead-up to the 2008 Olympics, the surveillance of NGO activities and of individual NGO activists intensified significantly, and many of these activists were harassed, put under house arrest, forced to leave the capital or arrested by state security forces. Since the government fears that stronger NGOs could limit state control over society, apolitical NGOs are the only ones tolerated by the regime as providers of beneficial services or useful information. For example, NGOs such as Global Giving have been welcomed in areas affected by natural disasters such as the Sichuan earthquake in May 2008, or by man-made disasters such as environmental pollution or AIDS, in part because governmental agencies lack the resources and/or the will to provide relief themselves.

Although guaranteed by the constitution, freedom of expression is still severely limited. But Chinese citizens increasingly make use of modern technologies such as the Internet and mobile phones to express their views, raise public awareness and criticize government actions. The government has reacted to this challenge with tightening controls on these technologies, shutting down critical Web sites and chat rooms, and interrupting access to foreign Web sites. The email correspondence of political activists is subject to surveillance, and several bloggers and cyber-dissidents have been detained.

Freedom of
expression

Most influential media is controlled and/or owned by state organs, and the work of journalists is heavily monitored by the CCP. Reporters Without Borders ranks China 167th out of 173 countries (2008) in terms of press freedom. Journalists deviating from the official line have their reports censored or are fired. Press censorship increased during the violent unrest in the Tibet Autonomous Region in March 2008, and again during the 2008 Olympics, with reporters being ordered not to report on sensitive topics such as popular unrest or food safety issues.

As the negative impact of the global financial crisis hit China in late 2008, with massive social unrest triggered by mass layoffs, the Chinese government loosened controls on bad news, authorizing news organizations to report on unrest. Since the Chinese government has evidently realized it is impossible to block any bad news completely, it now tries to control negative information and its impact by publicizing the news. It remains to be seen whether this move represents only a temporary loosening of media control or constitutes a new and lasting trend of liberalization. For foreign media the situation has slightly improved. Beginning in 2009, the governmental Xinhua News Agency no longer controls the distribution within China of information from foreign agencies, and no longer censors news by foreign agencies covering topics related to “national unity” or “social stability.” Since the Olympics, foreign journalists have been allowed to travel and report without seeking permission from provincial officials.

3 | Rule of Law

State power in China is vested in the National People's Congress, the State Council headed by the premier, and the president. But the Chinese political system is organized on the Leninist principle of "democratic centralism" which gives the CCP power of appointment and promotion over the people's congresses at all levels. Since both the State Council (the executive branch) and the Supreme People's Court (the judiciary) are answerable to the NPC, whose delegates are dependent on the approval of the CCP, there is no effective separation of power between the party and the state, nor is there effective separation of powers between the legislative, executive and judiciary branches of government. Therefore, no genuine system of checks and balances can be said to exist, nor are the CCP or state powers truly subordinate to the rule of law.

Separation of powers

Although direct interference by the CCP in legal cases has lessened in recent years, and plaintiffs against government officials have even won some recent court cases, the Chinese judiciary is not politically independent. Despite President Hu's stated commitment to the rule of law and his avowal of its importance for establishing a "socialist democracy" and "harmonious society," China's legal system remains weak. The constitution is not enforced as the supreme law of the land. Many judges, prosecutors and lawyers are corrupt and poorly trained. The bar lacks independence, since the All-China Lawyers Association is subordinate to the Ministry of Justice. In criminal and civil rights defense cases, lawyers' ability to gather evidence is restricted, and they themselves are often accused of violating the law when representing defendants. Some improvements are evident, however. More law schools have been opened, and higher education qualifications have been imposed on judges. In January 2007, the authority to review death sentences was returned to the Supreme People's Court, resulting in a visible decrease in death sentences and immediate executions.

Independent judiciary

Although laws against corruption are in place, implementation remains highly inadequate. This results from corruption being addressed in the vast majority of cases by Communist Party disciplinary organs; only a fraction of cases are submitted to state judicial organs for prosecution. Only at the lower administrative levels are corrupt government and party officials punished with any frequency. At the higher and central-government levels, many corrupt officials are able to escape punishment; only a few show cases have been given extensive media coverage in order to demonstrate that the government and the CCP are determined to rein in corruption. The Chinese public is highly frustrated with official corruption and with the inability of the government and party to rein it in. Corruption has been the primary cause of large-scale social unrest in the country.

Prosecution of office abuse

The constitution guarantees certain civil rights such as the freedoms of speech, of the press, of assembly, of association, of demonstration, of religious belief and of

Civil rights

person; nevertheless, the CCP and state organs frequently infringe upon these rights. For example, religious/spiritual groupings, such as underground Protestant churches and Catholic communities loyal to the pope are not tolerated by the authorities, and activists are frequently persecuted. Compelled resettlement due to large-scale governmental construction projects or illegal land grasps by local authorities violate people's property rights. Ethnic minorities face political and economic discrimination, as public life is dominated by Han Chinese and minority regions lack significant autonomy rights. Although the Chinese constitution stipulates that men and women enjoy equal rights, and legislation for the protection of women's rights has been in place since 1996, women's rights and opportunities are in practice still severely compromised in many parts of the PRC.

4 | Stability of Democratic Institutions

As discussed elsewhere in this report, institutions such as political parties, elections, the media, the judiciary, and government are all underdeveloped, because they are dominated by the CCP. There has been a slight opening in political competition at the lower levels, from the village to the township and county levels. The prospects for future democratization are not favorable, since the CCP leadership is not prepared to share power with other political actors, and constantly rules out the adoption of a Western model of pluralist democracy.

Performance of
democratic
institutions

Political leaders' interest in promoting internal party democracy has to do with their desire to placate social discontent and create a "harmonious society," in order to strengthen the CCP's hold on power. To this end, the CCP has endorsed direct elections of village and township leaders, and of their equivalent on urban residents' committees, and has encouraged greater transparency and popular participation in local governments. Elections of the delegations of people's congresses from the county, municipal, provincial and national levels are not freely competitive, but there are usually more candidates than seats at all levels. These measures are not intended to give people more say in public policies, but do aim at improving good governance and party legitimacy.

Commitment to
democratic
institutions

5 | Political and Social Integration

The party system is dominated by the CCP; even though eight other so-called 'democratic' parties are officially recognized, they are subordinate to the CCP. CCP membership has grown to 73 million, with private entrepreneurs and self-employed individuals being disproportionately high amongst new members. That can be interpreted to mean that the new urban middle class, as the "winner" of economic reforms, now constitutes the most important social base, and the backbone of the CCP. Peasants and urban industrial workers have in turn become marginalized.

Party system

In China, the system of cooperative associations is very heterogeneous, and is characterized by differences in relationships to the state. Former mass organizations are funded, controlled and supervised by the state, and mainly operate as purveyors of CCP policies to the respective membership groups. The majority of associations were established on the initiative of the state and can be viewed as GONGOs, or government-organized non-governmental organizations. However, NGOs established by non-governmental actors also exist, concentrating mainly on social issues such as environmental protection, animal welfare, representation of the interests of marginalized groups (women, the disabled, ethnic minorities, children), and providing services such as legal aid and consumer protection. There were 382,000 officially registered NGOs in 2008, up from 154,000 in 2000. The non-profit sector is thriving, largely comprised of informal, non-registered associations (approximately 2 million) which are tolerated by the state, and active in areas such as environmental protection, alumni activities or self-help. NGOs are poorly connected, lack organizational capacity and funding. The new Corporate Income Tax Law (in force since January 1, 2008) offers tax benefits for public and corporate charitable donations, an indication that the financial resources of NGOs may improve over time.

Interest groups

According to the World Values Survey, Chinese have a positive attitude toward democracy; 89.9% consider democracy – despite some problems – as the better form of government. However, the broad support for a responsible, incorruptible and stable form of government has not yet led to demands for political participation. Most Chinese still believe that a strong-handed government is needed to ensure political and social stability and order. Even if many Chinese today are ready to resort to public protests against egregious abuses of power by government officials, the overwhelming power of the state deters most citizens from demanding regularized democratic participatory rights, or from becoming personally engaged in politics.

Consent to
democratic norms

According to surveys, the level of interpersonal trust is high in China; in 2007, 79% of the population agreed that most people in society are trustworthy. Parochial trust, especially strong loyalty among family members, is particularly pronounced. Civic trust is also growing as citizens affected by severe problems such as environmental degradation, local government corruption, violations of basic human rights or other such problems organize for purposes of self-help. Occasionally, these associations are supported by activist lawyers. These groups are closely watched, and since they often aggressively expose social injustice, local governments in particular try to silence them by repressing activists and their leaders. However, the existence of interpersonal trust and the development of democracy are not interrelated. Instead, interpersonal trust in China rather seems to improve regime stability.

Associational
activities

II. Market Economy

6 | Level of Socioeconomic Development

China's HDI value reached 0.781 in 2006, but economic and social development is spread unevenly, with considerable discrepancies in wealth distribution between urban and rural areas as well as between provinces. The urban-rural income gap widened from 2.79:1 (2000) to 3.33:1 (2007), but slightly improved in 2008 to 3.19:1, because of increased prices for farm goods in most of 2008. The Gini coefficient is 46.9. Provincial level HDI also varies widely with Shanghai enjoying the highest HDI (0.9111) and Tibet the lowest (0.616).

Socioeconomic
barriers

Gender inequality is also increasing. China's GDI decreased to 0.776 in 2005, and the gender empowerment measure is 0.534. Women's participation in politics is declining; China's rank in the Inter-Parliamentary Union fell from rank 12 (1994) to rank 52 (2008). The total employment of women and the number of self-employed women has increased, but sex discrimination still exists in the labor market, and has tended to worsen.

Ethnic minorities are subject to social and economic exclusion and marginalization, with the majority of China's poor living in minority regions. About 20% of non-Han Chinese live on less than \$1 a day, compared to the national average of 10.4%. Political marginalization, infiltration of minority areas by Han Chinese, and economic backwardness have provoked often violent resistance and separatist movements, most prominently in the Muslim Xinjiang Uighur and Tibet Autonomous Regions, the latter of which witnessed large-scale, violent civil unrest in March 2008.

Economic indicators		2004	2005	2006	2007
GDP	\$ mn.	1931640.2	2235914	2657881.2	3382267.5
Growth of GDP	%	10.1	10.4	11.6	13.0
Inflation (CPI)	%	3.9	1.8	1.5	4.8
Unemployment	%	4.2	4.2	4.1	4.0

		2004	2005	2006	2007
Foreign direct investment	% of GDP	2.8	3.5	2.9	4.1
Export growth	%	28.4	24.3	23.3	19.9
Import growth	%	22.5	11.4	14.3	13.9
Current account balance	\$ mn.	68659.2	160818.3	253267.9	371832.6
Public debt	\$ mn.	89751.3	85043.8	88033.5	87653.4
External debt	\$ mn.	247679.3	283802.8	325076.5	373635.4
Total debt service	% of GNI	1.2	1.2	1.0	0.9
Cash surplus or deficit	% of GDP	-2.1	-1.6	-1.4	-
Tax Revenue	% of GDP	8.9	8.8	9.4	-
Government consumption	% of GDP	14.5	14.5	14.2	13.7
Public expnd. on edu.	% of GDP	-	-	-	-
Public expnd. on health	% of GDP	1.8	1.8	1.9	-
R&D expenditure	% of GDP	1.2	1.3	1.4	1.5
Military expenditure	% of GDP	2.0	2.0	2.0	2.0

Sources: The World Bank, World Development Indicators 2009 | UNESCO Institute for Statistics | International Labour Organization, Key Indicators of the Labour Market Database | Stockholm International Peace Research Institute (SIPRI), Yearbook: Armaments, Disarmament and International Security.

7 | Organization of the Market and Competition

Until the first PRC Anti-Monopoly Law came into effect on August 1, 2008, China had the Countering Unfair Competition Law, the main objective of which was to protect the rights and interests of businesses, consumers and the broader public against fakes, business bribes, misleading advertisements, the infringement of business secrets, and unfair competition practices on the part of government or government agencies through the abuse of administrative power. In practice, the government and its agencies are seldom punished for unfair practices such as local protectionism. Although the public sector has shrunk to less than 35% of GDP, the private sector continues to be discriminated against in terms of access to markets and capital. The state controls highly capitalized enterprises in such strategic sectors as petroleum and refining, metallurgy, electricity and telecommunications. However, it should be pointed out that many of these state-owned enterprises are profit-oriented and behave like private enterprises. Still, these SOEs have one unfair

Market-based
competition

advantage over the private sector in that they are not obliged to distribute dividends to the state, and can retain their profits for business expansion and acquisitions

The informal sector – including people employed by urban private enterprises, the self-employed, and rural migrant labor in informal employment – is steadily growing, rising from about 32 million individuals in 1995 to 125 million in recent estimates, and now accounts for 50% of total urban employment. It is also the fastest-growing sector of the urban labor market, absorbing laid-off employees from SOEs and low-skilled rural migrant workers.

In August 2008, the new Anti-Monopoly Law (AML) went into force. It prohibits monopoly agreements between competitors, abuse of dominant market position and administrative monopolies. It also aims at tearing down artificial trade barriers within China and thus eliminating local protectionism. Four agencies were given responsibility for enforcing the AML: the Anti-Monopoly Investigation Bureau of the Ministry of Commerce (MOFCOM), the Pricing Division of the State Development and Reform Commission (SDRC) and the Anti-Monopoly and Anti-Unfair Competition Bureau of the State Administration for Industry and Commerce (SAIC), to be coordinated by the Anti-Monopoly Commission. This latter body is invested with the authority to make competition policies, organize the investigation and assessment of market competition, make and publish anti-monopoly guidelines, and coordinate anti-monopoly enforcement. The state continues to control some strategic sectors (including national defense, power production, petroleum, gas, petrochemicals, coal, civil aviation and shipping). It remains to be seen whether the AML will effectively boost competition and rein in administrative abuse of power by government agencies.

Anti-monopoly
policy

Since China's accession to the WTO, foreign trade has been continually liberalized; direct intervention in trade has decreased, import barriers have been reduced and the average tariff rates have been lowered to below 10%, with many machinery and material inputs required for manufacturing exempt from tariff. The PRC has also entered into regional and bilateral free trade agreements. The abolition of export barriers is lagging behind to a certain degree; some restrictions, such as prohibitions and licensing requirements, are still in place. Occasionally, the government introduces ad hoc measures such as interim export taxes and value added tax (VAT) rebates in order to manipulate the import or export quantities of certain goods, depending on the domestic supply situation.

Liberalization of
foreign trade

In the period leading up to the current global financial crisis, Chinese banks were transformed thanks to strong economic growth, a recapitalization by the Chinese central bank, which spent nearly \$500 billion in recent years to clean up the banks' bad debts and non-performing loans, and to privatization policies that allowed domestic and foreign investors to be equity shareholders or minority owners of state-owned commercial banks. Not only did these outside investors inject new

Banking system

capital into the banks, but they also improved internal governance structures and risk management policies. In addition, there are now strong regulatory agencies to supervise the banks. Yet many problems remain. The state remains the majority shareholder in many large commercial banks, and still dictates the allocation of credit. It has only partially deregulated the interest rates banks offer on deposits and charge on loans. The banks rely heavily on interest income and concentrate on corporate lending, especially to SOEs. Chinese banks have some limited exposure to the global financial crisis in that they have invested \$20 billion in collateralized debt obligations (CDO) backed by subprime mortgages, and were forced to write the value of these assets down to less than \$7 billion. In addition, they had bought \$750 million in Lehman Brothers paper, much which was related to wealth management products. In the current economic downturn, banks are most vulnerable to export bill delinquencies, defaults in the property sector, slowing deposit growth and squeezed margins.

8 | Currency and Price Stability

Rising inflation remains a problem. Inflation averaged 2.6% between 2003 and 2007, but reached 4.8% in 2007. It soared to 8.7% (year on year) in February 2008, moderated to 8.5% in April, and declined and stabilized at 6.3% by July 2008. The price inflation was mostly due to increases in food prices. However, the producer price index continued to rise, reaching more than 10% (year to year) in August 2008. In response to inflation, the government raised the reserve ratios for banks to 17.5% in 2008, and raised the base lending rate (the equivalent of prime rate). The government also put a cap on energy prices. Partly in response to international pressure, and partly to cool an overheated economy thriving on exports, the government allowed the yuan to appreciate at 1% per month beginning in November 2007, so that there was a 10% appreciation in the value by July 2008, or a 21% appreciation since the government first allowed the yuan to float in July 2005. The unintended consequence of this steady appreciation was an even greater inflow of foreign capital to China, creating further inflationary pressure as the central bank (the People's Bank of China, PBOC) tried to sterilize the huge inflow of foreign exchange. The yuan's appreciation, in addition to higher labor costs, had the effect of making Chinese exports less competitive, so that the export sector had already slowed down somewhat in the middle of the year 2008, even before the global financial crisis hit the country hard. In July of that year, the government suspended the yuan's appreciation, and in September cut interest rates and lowered bank reserve requirements in hopes of preserving economic growth.

Anti-inflation /
forex policy

Macroeconomic stability is of utmost importance to the Chinese government. From 2003 to 2007, the government achieved double-digit economic growth for five years in a row. Given that the global financial crisis had hit China with unexpected

Macrostability

severity by October 2008, the government and external analysts alike strongly doubt that these growth rates can be sustained. The main problem is that China's economy is not self-supporting, with a foundation in national consumption, but relies heavily on fixed-asset investment and exports. In late 2008, sales from export-oriented industries caved in as demand from the United States and Europe dropped sharply, resulting in a first wave of mass layoffs and related social unrest. Since the Chinese government is most concerned with the maintenance of social order and stability in order to protect its own legitimacy and maintenance of power, it acted resolutely and launched a stimulus package worth four trillion yuan (about \$586 billion) – actually a mix of new funding and existing commitments over the next two years – in order to boost domestic consumption. The actual sum is projected to be 1.18 trillion yuan, to be invested in rural infrastructure, major transport infrastructure, health and education, urban water, sewage, energy conservation, affordable housing, and research and development projects.

With foreign exchange reserves amounting to \$1.9 trillion, China can afford this drastic public spending. However, as the Chinese sovereign wealth fund China Investment Corporation lost considerable amounts of money in overseas investments such as Blackstone, the stimulus announcement set off a heated debate – within the government, in the media and on the Internet – on how the foreign reserves should best be used.

9 | Private Property

In October 2007, China's first private property rights law came into force. The law "protects the lawful property of individuals," or the property rights of private businesses, homebuyers, car-owners, and so on. It also aims at protecting state-owned assets and prohibiting the illegal possession, destruction or looting of state property by private persons. However, all land ownership remains with the state; there are no secure property rights for peasants. In late 2008, the CCP decided to allow peasants to lease their contracted farmland or transfer their land-use rights for a fair price when they migrate to urban areas. This rule also gives farmers the possibility to merge their plots and employ modern farming technologies on larger fields, thereby boosting productivity and incomes. Since final control over the land still remains with local party functionaries, the rule provides no safeguard against illegal land seizures by corrupt officials. According to some estimates, up to 40 million peasants have already lost their land use rights this way and are now landless.

Property rights

Private enterprises increasingly form the backbone of the Chinese economy; by 2010, 75% of GDP will be generated by the private sector, and private enterprises already today pay more taxes than SOEs. The private sector absorbs 75% of the urban workforce. Although private enterprises will also benefit from the private

Private enterprise

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 pressures to pay illegal fees.

The transformation of SOEs into public corporations with diverse forms of ownership continues. By the end of 2006, the central state controlled only 159 SOEs in key industrial sectors; this number will drop to between 80 and 100 by 2010. Most of these SOEs are in strategic sectors like telecommunications, metallurgy or petrochemicals, where the state supports their monopoly positions. Many of these report that they are profitable, mostly because they do not have to distribute dividends to the state, the majority owner, and can retain the profits for merger and acquisitions and overseas expansion. The government is in the process of changing this privilege, so it can rein in SOEs spending and receive additional revenue.

10 | Welfare Regime

Social security systems covering pensions, health care, unemployment, accidents and maternal care are in place in China, but are largely city-based. The household registration system (hukou) has excluded rural residents from the social safety net, although local governments have started to modify some of the restrictions that permanently disadvantage rural residents. Thus the current unemployment insurance covers employees of urban enterprises and state institutions, but not rural peasants. Though obliged by law to provide social insurance for migrant workers, many employers do not pay the necessary premiums. In rural areas, cooperative medical systems have broken down for lack of funding, leaving more than 90% of the rural population with no health insurance. Even in cities, the health care system is unreliable. Hospitals and doctors routinely charge arbitrary fees, or insist on payment of bribes for their service, making health care unaffordable for many and often causing public resentment. Uncertainty about social welfare provision and future educational costs leads to extremely high saving rates among the population. This, in turn, undermines national consumption that might support China's domestic economy, particularly critical due to the sharp decline in export and manufacturing brought about by the financial crisis in late 2008. In order to assure social stability and sustain economic growth, the Chinese government announced in January 2009 that it planned to spend \$123 billion to provide universal health coverage by 2020.

Social safety nets

Access to education, social security systems and public services is uneven throughout the country, despite the government's efforts in recent years to spread the provision of basic social services to the countryside, and to the western and ethnic minority regions. Twice as many girls as boys lack schooling. In 2006, 70% of the new expenditures on education went to assure that primary and middle-school

Equal opportunity

pupils in rural areas receive free compulsory education. There remains a gender gap in adult literacy; in 2006, 95.13% of men and 86.28% of women were literate. The children of migrant workers face discrimination in access to schooling, either because they are not eligible, or because the fees charged for migrant worker children are beyond their means. Girls and women are still often denied equal access to health care, education, political participation and economic opportunities. The “survival gap: between girls and boys is increasing, with child mortality rates rising at 0.5% a year for girls and falling at 2.3% a year for boys. The proportion of women in institutions of higher learning, in post-graduate ranks and among doctoral students is respectively 45.7%, 44.2% and 31.4%. Women hold 20% of the country’s parliamentary seats and 6% of ministerial positions. Finally, the ratio of female to male earned income is 0.64.

11 | Economic Performance

From 2003 to 2007, the Chinese economy maintained very high annual average growth rates of 10.6% (reaching 13% in 2007). GDP per capita reached 18,700 yuan in 2007. But growth slowed substantially by mid-2008, partly because the government closed some factories near cities where the Olympics events were held in order to control air pollution. By the last quarter of 2008, the growth rate was near zero, reflecting the severity of the global recession, leaving the annualized growth rate for 2008 at about 9%.

Output strength

Because of a sharp decline in exports in the second half of 2008, and an even steeper decline in imports because of weak domestic demands, foreign direct investment (FDI) inflow dropped steadily beginning in July 2008. By the end of 2008, the PRC amassed a trade surplus of \$290 billion. In 2008, industrial output declined by 5.6% over the previous year. The greatest impact from the decline in export has been the closure of 670,000 factories in the coastal provinces, leading to a sharp increase in unemployment, especially among the rural migrant workers. The ranks of unemployed migrant workers have been estimated at 20 million people. The official rate for urban unemployment (excluding migrant and rural workers) is 4.2% (2008); however, the RAND Corporation estimates total unemployment today to be near 23%. Because of robust economic growth in 2007, China ran up a budget surplus equal to 0.7% of its GDP. But stimulus spending in the last few months of 2008, will lead to a budget deficit for that year of about 111 billion yuan (\$14.26 billion), or 0.4% of its GDP. According to the government, for the full year of 2008, Chinese government revenues increased 19.5 percent to 6,132 trillion yuan, while expenditures rose 25.4 percent to 6,243 trillion yuan.

The 2008 global financial crisis poses great risks for China. Domestic consumption will not be strong enough to substitute for exports as an impetus for growth. Thus, according to a World Bank forecast, the economy will grow by only 7.5% in 2009.

However, an annual growth of at least 8% is needed to provide necessary employment opportunities for those entering the work force. The Chinese government announced a massive stimulus package of 4 trillion yuan in late 2008 to boost the economy over a period of two years, but the direct sum of money coming from the central government will probably be only 1.18 trillion yuan.

12 | Sustainability

In the face of severe environmental degradation and its negative impact on economic development and social stability, the Chinese government has given increasing public support to the idea of sustainable development, using this as part of the “scientific development” concept enshrined in the party statute in 2007. Leaders have said they intend to cut energy consumption and pollutant emissions by 4% and 2% yearly, respectively. The State Environmental Protection Agency was upgraded to ministerial rank in March 2008, giving it more clout in implementing national environmental policies. There are several laws in place which deal with lean production, energy saving, renewable energies and related concepts, ensuring that environmental concerns are now enshrined in the institutional framework. However, implementation of environmental policies is still woefully inadequate. Due to resistance by local governments trying to protect local industries and employment, national environmental regulations are violated, and efforts to establish the concept of a “green GDP” were derailed in 2007. The Ministry of Environmental Protection lacks the resources and authority to compel local authorities to rein in industrial polluters by implementing national environmental guidelines. New incentives for compliance with environmental laws have been introduced in the evaluation criteria of the performance of local officials, but enforcement of environmental protection remains weak.

Environmental
policy

China’s expenditure on education accounted for 3.01% of GDP in 2006, which is less than world average, but the government is planning to increase public spending on education to 6% of GDP by 2010. In the last two decades, public expenditure on education tended to favor higher education at the expense of primary and secondary education. But in the last few years, the government has taken steps to correct that imbalance. From 2007 – 2008, the education budget has increased by 45% to 156.2 billion yuan, much of this focused on supporting compulsory primary education in the rural areas. From 2006 – 2010, \$26.94 billion will be spent to eliminate tuition and fees for all rural students, and to ensure that every child in rural areas receives nine years of free compulsory education. Since 2005, the government has also increased support for vocational schools in order to counter rising unemployment levels amongst university graduates who lack skills-based training. From 2006 – 2010, vocational schools will receive funding amounting to 10 billion yuan.

Education policy /
R&D

China spent 56.73 billion yuan on R&D in 2006. Spending on R&D as a percentage of GDP has risen from 0.6% (1995) to 1.43% (2006) and the government plans to increase this figure to 2% by 2010. R&D is heavily driven by foreign companies' investments and is dispersed very unevenly across the country, with high R&D intensity concentrated in Beijing, Shanghai, Shaanxi and Sichuan. China has also raised its number of applications for new patents, a figure predicted to pass that of Japan, the leader to date, by 2012.

Transformation Management

I. Level of Difficulty

Structural constraints in China are rising. Environmental degradation has undermined the foundations of development. In May 2008, a major earthquake shattered Sichuan province, leaving 70,000 dead, 374,000 injured and 5 million homeless. HIV/AIDS is on the rise in China; official statistics account for 700,000 HIV/AIDS carriers in 2007.

Structural
constraints

Economic growth in the last decade has become too dependent on investment in fixed assets and FDI (the two together account for 40% of GDP), and exports (36% of GDP), at the expense of domestic consumption. The structure of Chinese industries has also been distorted in the last few years, with capital- and- energy-intensive industries such as cement, steel, and aluminum production replacing labor-intensive industries (garments, shoes, etc.) as the most profitable exports. Such structural imbalance is the major source of pollution in China; moreover, those energy-intensive industries are the driving force for China's relentless search for raw materials world-wide. All these structural imbalances have produced a very high rate of national savings and huge foreign exchange reserves that further distort the global economic structure, with frugal Chinese consumers lending to profligate American consumers.

There is no robust tradition of civil society in China. NGOs and voluntary organizations have emerged only recently. Since the state controls and intrudes in the work of these organizations, and many of them remain particularistic rather than public-regarding in their orientation, NGOs and voluntary organizations are still not in a position to provide robust channels for popular unease. Consequently, uncontrolled eruptions of social discontented have increased; in 2006, there occurred more than 90,000 public disturbances, often violent, up from 87,000 such "mass incidents" in 2005. However, these protests are not organized to challenge the communist regime itself, but rather target specific wrongdoings by local authorities. In fact, student protests in particular have frequently been expressions of nationalist sentiments in support of the regime. In recent years, the Internet has increasingly served as a medium for dissent, despite government's efforts to shut down critical Web sites.

Civil society
traditions

As the wealth gaps and levels of access to health care, education and other social services widen between the haves and have-nots, social tensions have also intensified. Relations between the majority Han Chinese and minority ethnic groups such as Tibetans, Uighurs and Inner Mongolians have also deteriorated. While the CCP and the government have preferential policies in place for minorities, and publicly favor the development of minority languages, cultures, and traditions to strengthen their autonomy, they do not hesitate to condemn any minority activities not sponsored by the government as “splittist” and detrimental to national unity. Tibetan and Uighur dissidents on the other hand, have dug in their heels and resorted to violence while demanding genuine autonomy, even though many of the minority regions survive today on financial subsidies and have no hope of being financially independent. Thus, some of the ethnic cleavages in China seem deeper now than ever before.

Conflict intensity

II. Management Performance

14 | Steering Capability

The Chinese government’s two main priorities are social stability and economic development. Towards these ends have been applied policies such as more investment in rural health care and education, greater transparency in government, the extension of election of party officials at higher local levels, the abolition of agricultural tax, the pursuit of the Western Development Program, and the institutionalization of a fairer, if not politically independent judiciary.

Prioritization

Regarding economic development, the present leadership no longer favors economic growth at all cost, but has decided to pursue a more sustainable development, with greater emphasis on social justice, equality and environmental protection. In the face of the global financial crisis, the government acted quickly and decisively to shift priorities, drastically increasing public spending on social welfare, public health, rural development and infrastructure construction in order to boost domestic consumption. However, there are concerns that these funds will be misused by corrupt local officials for unnecessary, prestigious pet projects.

China’s ability to carry out successful economic reform has been well documented. From 1978 to the present, the government has been credited for implementing a household responsibility system which dramatically increased agricultural production and rural household income, and for carrying out reforms of SOEs, the banking system, the labor market, and trade restrictions, with the overall effect of

Implementation

transforming the Chinese economy to an export-led, manufacturing economy. Yet, there are limits to the government's ability to carry out further structural reform that would correct the imbalances that have developed – for instance, economic growth has become too dependent on capital investment and export at the expense of domestic consumption. Manufacturing has shifted from labor-intensive to capital- and energy-intensive production, with less job creation as a result. The four large state-owned commercial banks pursue lending practices which favor SOEs at the expense of private enterprises. Huge foreign exchange reserves (\$1.9 trillion by the end of 2008) have created an imbalanced global economy in which a ballooning U.S. deficit is sustained by the savings of the Chinese and the willingness of the Chinese government to buy and hold U.S. Treasury bonds. It has also hampered the Chinese government's efforts to control domestic inflation. The efficacy of the emergency economic stimulus measures taken in late 2008 will depend on how local governments implement the policy, and whether vested interests have their sway. As details of the stimulus plan have been unveiled, it seems that the SOEs in 10 big industries will be favored at the expense of the small-and-medium enterprises that have been the generator of most of the jobs in the past. In the same way as leaders before them, the Chinese leadership under President Hu does not intend to implement any democratic reforms as these are understood by the BTI.

The Chinese leadership has acknowledged that the past prioritization of unbridled economic development has brought about serious income disparities, human hardship and the deterioration of the environment. Therefore President Hu has fought successfully to place a greater emphasis on social equality and justice, and environmental protection. These reforms face strong opposition from special interests who benefit from privileged access to resources and influential decision makers, and who hamper the implementation of reform measures. Judging from the government's quick responses to the Sichuan earthquake, and the policy reversals in the last few months, when the leadership announced big increases in social spending and agricultural subsidies, the introduction of a new rural health-care scheme and the restoration of tax rebates for exports of labor-intensive products, Chinese leaders appear flexible and adaptive. Moreover, relative institutional stability in China has allowed for the accumulation of data, experience and knowledge. Hence, even though greater government transparency, more press freedom and public participation can facilitate further policy learning, one can hardly fault the Chinese leaders and institutions like the State Development and Reform Commission for their lack of learning capacity.

Policy learning

15 | Resource Efficiency

Although there is continuous improvement in civil service personnel, budget resources, and public administration organization, resources are not used efficiently.

Efficient use of assets

The size of the civil service bureaucracy remains bloated; from 1996 to 2006, the number of civil servants increased by 57%, leaving the ratio of citizens to civil servant ratio at 34:1. The quality of the civil service has improved; meritocracy through competitive examination and task-related performance appraisal has been introduced, and the vast majority of civil servants today hold university degrees. Corruption is still rampant, and the party nomenklatura still influences the personnel appointment to the upper levels of government and party bureaucracies, putting party loyalty and support for present leaders before professional competence.

China's budgetary system was highly decentralized until the 1994 reform, when the central government once again took over control of tax revenue collection. However, budgetary expenditures remain relatively decentralized, with local governments responsible for almost 70% of total government expenditures. A small portion of the local government expenditures come from rule-based tax rebates, but about 48% of the tax transfers to local government are discretionary, ad hoc payments from the center. Thus, there is no guarantee that poor provinces or regions receive the much-needed tax rebates. The discretionary rebates also create the perverse incentive for local officials to be inefficient and ineffective, so that they can receive higher levels of budgetary transfers from the central government.

During the period under review, the Chinese government often had difficulty reconciling conflicting policy objectives and interests. The central government places more emphasis on sustainable growth, while local governments mostly thwart this policy by fuelling excess development in their localities. The government's failure to reconcile the need to cool down the economy and rein in the excessive growth of foreign currency reserves with the necessity to protect cheap exports as the main engine of growth, absent sufficient domestic consumption, led to 11.9% growth in 2007 despite government targets of just 8%. As the global financial crisis hit China in late 2008, the government acted very coherently, taking coordinated policy measures such as lifting price controls, increasing government spending and cutting interest rates in order to spur domestic consumption and boost the economy. Local authorities are being put under stricter control and supervision in order to make sure that these government policies are fully implemented.

Policy
coordination

Corruption has been the greatest cause of social instability in China. The leaders are aware of this, but have so far been ineffective in eradicating the problem. The National People's Congress ratified the U.N. Convention Against Corruption in 2005, in hopes of learning from other countries' anti-corruption experiences and improving China's effectiveness in fighting transnational crimes of corruption. The CCP Central Commission for Discipline Inspection (CCDI) is the party's internal anti-corruption body, tasked with enforcing integrity among party cadres. During 2008, the CCDI punished more than 4,900 officials above county-head level for

Anti-corruption
policy

corruption, but this is still a drop in the bucket. By and large, the CCP's anti-corruption work is limited to mass campaigns and moral exhortations, and has proven largely unsuccessful. Some high-profile corruption cases have been widely publicized as deterrence. Thus, only low-level, small-scale corruption has decreased, whereas high-level, large-scale corruption continues to worsen. The lack of a competitive political processes, an independent judiciary and a free press, as well as the involvement of high-ranking political figures in corrupt activities all exacerbate the ineffectiveness of anti-corruption measures. Corrupt officials and cadres increasingly collaborate with local organized criminal groups. In some parts of the country, corruption has developed the potential to jeopardize the state's monopoly of power.

16 | Consensus-Building

The fervent expression of nationalism during the Tibetan uprising in March 2008 and the demonstrations of national pride during the Olympics indicate that there is broad consensus among Chinese leaders and the public that maintenance of territorial integrity, national sovereignty and economic growth should be the goals of the government. President Hu's "scientific development" concept, which was enshrined in the CCP constitution in late 2007, suggests that the majority of the party members agree that development needs to be rendered sustainable through greater environmental protection and attention to issues of social justice and equality. There is also a strong overall consensus among leaders and a large share of the public that a Western democratic form of government is not an option for China, even if people want greater accountability in government. There is also muted dissent on important government policies, such as how the foreign exchange reserves should best be used.

Consensus on goals

President Hu consolidated his power and emerged from the 17th CCP Congress in October 2007 as an undisputed leader. He appointed some confidants to important party and government positions. These officials are pragmatists and not ideological. This means that destructive internal strife within the party is unlikely in the years to come, and there will very likely be a smooth transition to the fifth generation of leadership in 2012.

Anti-democratic
veto actors

Two decades of rapid economic development have resulted in an ever-widening wealth gap between those with access to education, health care, social security and a good standard of living and those without. This has created social tensions that frequently erupt in violence. As the economy slows because of the global financial crisis, yet more people will fall behind economically and socially, resulting in more social unrest. Sensitive to the implications of an economic downturn, the government has pledged more resources to social welfare in the next few years. The other main cleavage is between the majority Han population and the ethnic and

Cleavage /
conflict
management

religious Tibetan minority. The tension between these groups is worsening, despite some government efforts at affirmative action in the minority regions to support minorities.

The political decision-making process is dominated in essence by internal debates within the CCP organs. However, since 2000, the government has tried to elicit citizen policy-making input by holding public hearings on pending national legislation, and urgent present-day issues such as health care, education and especially environmental problems and corruption are discussed broadly in society – not least with the help of the Internet. Nevertheless, public opinion has little influence over political decisions. Quite to the contrary, in cases in which public debates become too explicitly critical of the party or government, the debates are suppressed and individuals leading these debates face harassment and even prosecution.

Civil society participation

As far as the major political injustices of the past – the political persecutions during the Cultural Revolution and the 1989 Tiananmen massacre – are concerned, the Chinese government remains unprepared to acknowledge the mistakes made by past leaders. Any attempt to redress historical wrongs is prevented.

Reconciliation

17 | International Cooperation

The PRC maintains and has expanded cooperative ties with external actors such as the IMF, the World Bank, the WTO and the Asian Development Bank (ADB), as well as with foreign governments, in order to obtain support for ongoing economic reforms. Some nations, including Japan and Germany, have cancelled their financial assistance to China and have concentrated instead on technical cooperation, focusing mainly on the transfer of green technologies, sustainable development, health care, social security systems, and legal reforms. China makes efficient use of this support, particularly in areas where it is technologically backward, such as renewable energy sources and energy conservation.

Effective use of support

China is a generally reliable member of the international community and a mostly dependable partner in bilateral relations. Old sources of conflict remain, mainly regarding foreign trade and WTO commitments, even as newly contentious issues such as China's hunger for resources and the country's steep increases in emissions of greenhouse gases have emerged. Major trading partners such as the European Union and the United States are frustrated that China still has not effectively reigned in rampant intellectual property infringements. A number of food safety scandals in 2007 and 2008 also gravely shook these trading partners' confidence in Chinese goods. The European Union and the United States are unhappy with what they regard as asymmetric bilateral trade; the EU's trade deficit with China in 2007 was €160 billion euro, while the U.S. deficit amounted to \$256.3 billion. Frictions

Credibility

with the United States and the European Union over China's foreign exchange policies have deepened, as both still accuse China of keeping the yuan artificially undervalued in order to subsidize exports. The international community is also annoyed by China's lack of political will and insufficient concrete contributions to the reduction of greenhouse gases. Finally, foreign governments and many international NGOs are disappointed that the government failed to live up to the promises it made to improve human rights as a precondition for hosting the 2008 Olympics.

Cooperation between the PRC and East Asian nations, especially with ASEAN, further improved during the period of this review. China-ASEAN bilateral trade totaled \$202.5 billion in 2007, the equivalent of 10% of China's total trade volume. Although ASEAN leaders are concerned about potential threats from China's economic might, both sides are strongly committed to creating a free-trade zone by 2010. In 2008, free trade agreements (FTAs) were signed with Singapore and New Zealand. China and ASEAN agreed on a code of conduct for the peaceful settlement of territorial disputes. China has worked hard to expand its political and economic influence in South Asia. In late 2006, China and India agreed on a "Ten Pillar Strategy" aimed at further improving bilateral relations, including plans to double bilateral trade to \$40 billion by 2010, hold regular summits, and pursue close cooperation as "leaders of the developing world" in international forums such as the World Bank. China also signed an FTA with Pakistan. In the context of the Asia-Pacific Economic Cooperation (APEC), China is improving political and economic relations with Latin American nations and has signed FTAs with Chile and Peru. Cooperation with Central Asian nations such as Russia, Kazakhstan, Kyrgyzstan, Tajikistan, and Uzbekistan in the areas of the economy and security (Shanghai Cooperation Organization), as well as in the areas of fighting money laundering and terrorism (Eurasian Group on Combating Money Laundering and Financing of Terrorism – EAG) is deepening.

Regional
cooperation

Strategic Outlook

During the period under review, economic development and transformation progressed rapidly but severe structural problems and risks persisted. In quantitative terms, economic growth was stronger than anticipated during the first half of 2008, but is too dependent on exports and fixed-asset investment. Domestic consumption is insufficient to sustain economic growth following the collapse of the export sector as a result of the global financial crisis. The government's reaction to the crisis was swift and decisive, even though details on the 4 billion yuan stimulus package were still lacking at the time of writing. The government has conceded the necessity for massive government investment in social welfare programs such as universal health insurance and education, since excess popular saving, mainly induced by citizens' need to build up financial reserves for risks such as illness and unemployment which are not (sufficiently) covered by social security schemes, is a major hindrance to increased domestic consumption.

China's future growth must also take sustainability and energy efficiency into account. China is the world's biggest emitter of greenhouse gases, and its lack of will to cooperate with developed nations on this problem increases international tensions. At home, ecological damages brought about by two decades of super-fast economic development pose a severe challenge to sustainable economic and social development. Developed nations should work hard to integrate China into the relevant global regulatory regimes and to exact substantial commitments from the Chinese government. Commercial and noncommercial transfers of green technology to China will be essential for decelerating ecological degradation.

Societal development also faces severe challenges. Increasing disparities in the distribution of wealth and opportunities cause social tensions and violent unrest. The Chinese government must not only adopt measures that promote a more equitable distribution of wealth, but which also create legitimate channels for people to redress their grievances. Thus, nascent civil society elements such as NGOs, self-help groups and lawyer-activists supporting the disadvantaged should not be suppressed and intimidated – as was particularly the case before and during the 2008 Olympics. More foreign NGOs should be allowed to operate in China providing financial and operational support to their Chinese counterparts.

In order to successfully handle the tasks ahead, and particularly the impact of the global financial crisis, the Chinese government needs a high level of steering capacity. However, rampant corruption and local governmental arbitrariness are eroding the authority and legitimacy of the government, even threatening the efficient implementation of economic stimulus programs initiated by the central government. The lack of mechanisms such as a free press and independent judiciary, which are indispensable for successfully controlling arbitrary officials and corruption, adds to the difficulties ahead. If China should succeed in making good on the stimulus package, especially if resources are indeed spent on building a social safety net, then the foundations for a more sound economic development will be laid, shifting the economy from being too dependent on exports and fixed asset investment to one animated by domestic consumption.