

BTI 2014 | China Country Report

	scale	score	rank	trend
Status Index	1-10	5.01	# 82 of 129	
Political Transformation	1-10	3.33	# 113 of 129	➔
Economic Transformation	1-10	6.68	# 35 of 129	➔
Management Index	1-10	4.92	# 66 of 129	

This report is part of the Bertelsmann Stiftung’s Transformation Index (BTI) 2014. It covers the period from 31 January 2011 to 31 January 2013. 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	1350.7	HDI	0.699	GDP p.c.	\$	9233.0
Pop. growth ¹	% p.a.	0.5	HDI rank of 187	101	Gini Index		42.1
Life expectancy	years	75.0	UN Education Index	0.627	Poverty ³	%	27.2
Urban population	%	51.8	Gender inequality ²	0.213	Aid per capita	\$	0.5

Sources: The World Bank, World Development Indicators 2013 | UNDP, Human Development Report 2013. Footnotes: (1) Average annual growth rate. (2) Gender Inequality Index (GII). (3) Percentage of population living on less than \$2 a day.

Executive Summary

The years 2011 and 2012 turned out to be one of the most turbulent in China's post-Tiananmen history. The road to the 18th Chinese Communist Party congress in November 2012 was overshadowed by the Bo Xilai affair, which revealed massive abuses of power and corruption up to the highest ranks in China's political elite, challenges to the institutionalization of succession politics and deep rifts within the Chinese Communist Party (CCP) with regard to overall policy direction. The congress ended with both the more reform-minded and leftist-populist wings of the party clipped and a return to mainstream, consensus-style politics. The new leadership repeated its pledge to fight corruption and called for a new (i.e., more humble, closer-to-the-people) working style but did not hint at any political reform agenda. Thus, any calls for increased political freedom, competition or participation are likely to be subdued. The biggest challenges for the Xi Jinping/Li Keqiang administration are twofold. The long-held image of the central party leadership as being competent and less prone to corruption has been shattered; and among the population, an atmosphere of permanent distrust, frustration and cynicism has taken hold, not least propelled by micro bloggers who have publicized gross cases of graft by officials against the backdrop of increasing social inequality. In addition, cracks have appeared in party loyalty and party hierarchies have decayed, as demonstrated by a rise in capital flight abroad. A proliferation of players (such as local governments and state-owned companies) with vested interests challenges the central leadership's ability to effectively address problems generated by a volatile international context and a fragile economy at home. Of the latter, two were of special importance in the period under review. These were longer-term structural problems (preferential treatment of the state economy vis-à-vis private business, over-dependence on investment with private consumption lagging behind, financial repression to the detriment of private savings, rising labor costs due to a structural shift in the working population) that coalesced with short-term challenges (decreasing demand from the European Union due to the euro crisis, efforts to reign in speculative trends in the housing market) and produced the slowest yearly growth rate (7.8% in 2012) since 1999. To fight inflation (for much of 2011) and boost the economy (in the second part of 2012) the

leadership relied on administrative, non-market quick-fix measures in monetary and fiscal policy instead of finally shifting to structural reforms in favor of a more balanced, sustainable, consumer-led development path.

In its external affairs, China was able to increase its weight and importance in the world economy as a major engine of growth. However, at the same time, trade and investment relations with major partners (United States, European Union and Japan) were characterized by rising tensions. China's efforts to improve its image abroad (not least by cultivating its "soft power") were wrecked in Asia due to escalations in eastern territorial conflicts (Senkaku/Diaoyu islands) and in the South China Sea (Paracel, Spratly Islands) as well as the ongoing ambitious modernization program of the Chinese People's Liberation Army.

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 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 pro-democracy movement led by students, there have been no attempts to increase political accountability, competition or even initialize democratic reforms. In the aftermath of the "incident," which remains taboo in the official media, 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 economic area and to reject any meaningful political reforms and liberalization.

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 been driven down somewhat only very recently through 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. In fact, according to official Chinese statistics, only about 13% of the population lives in poverty today. 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.

Rampant corruption, an inefficient legal system, government agencies unable to properly implement laws and regulations, and a lack of sustainability in economic development constitute other serious problems. The deterioration of the environment will cause enormous economic and social costs in the future and burden 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, befitting career opportunities or more accountable government. Although the party has been able to register the support of the young, well-educated urban middle-class, 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) seems determined to stick to the overall policy line as set by its predecessor: no longer to concentrate exclusively on economic growth but also to take the often negative social consequences of economic development into consideration. While some changes in policy style have been notable in the immediate aftermath of the party congress, there are no signs at all that the new leadership has 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 and, with the exception of secessionist movements in the autonomous regions Tibet and Xinjiang, virtually no competition with the state's monopoly on the use of force.

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. 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. 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 2011 and 2012 by a massive increase in security forces to the regions. However, the number of Tibetans who have self-immolated in protest has shown the degree of continuing dissatisfaction with the current situation.

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 yet strictly controlled. 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 is 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. House churches face occasional harassment.

Question
Score

Monopoly on the
use of force
9

State identity
8

No interference of
religious dogmas
10

In China, a fundamental and sufficiently differentiated bureaucratic structure extends over the entire territory. In some rural areas, however, public infrastructure is 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 are implemented correctly at the city, county and township levels.

Basic
administration
8

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, these are not designed as democratic experiments but as instruments to make governance in a one-party system more effective. The nomination of candidates, voter eligibility and election campaigns are still subject to local government and party control and manipulation.

Free and fair
elections
1

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.

Effective power to
govern
2

Although freedom of association and assembly is guaranteed by the constitution, the state often interferes with this right. The number of registered civil society organizations in China has increased from 154,000 (2000) to 460,000 (2012), 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. 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

Association /
assembly rights
2

affected people's lives (such as issues of environmental protection; health care/AIDS; support for the disabled and orphans). Supporting such NGOs is an element of the new strategy of "social management" and is especially welcome where governmental agencies lack the funds and/or the will to provide relief themselves.

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 work of journalists is heavily censored by the CCP, earning China rank 174 out of 178 countries according to Reporters without Borders (2012). Generally speaking, official news reporting meets with widespread suspicion by the population. Some (state-owned) media outlets follow a market logic by proclaiming nationalist content (e.g., in China's island disputes with its neighbors) even if this is not in sync with official policy positions. Foreign media companies also face frequent discrimination: After critical reports on the wealth of the families of Wen Jiabao and Xi Jinping in 2012, the Chinese websites of the New York Times and the English website of Bloomberg were blocked. In addition, the re-accreditation of a New York Times correspondent was delayed, forcing him to leave the country at the end of 2012. Because of her critical reporting, the Beijing correspondent of Al Jazeera was expelled from China, forcing the news channel to close its Beijing bureau.

Freedom of
expression
2

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. Therefore, a system of checks and balances does not exist.

Separation of
powers
1

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.

Independent
judiciary
2

Although laws against corruption are in place, they are rarely enforced. This results from the overwhelming majority of official corruption cases being handled by Communist Party's disciplinary organs; merely a fraction of cases are submitted to the state judicial organs for prosecution. Only at the lower administrative levels are corrupt government and party officials punished rather frequently. At the higher and central levels, corrupt officials are mostly able to escape punishment; only a few "show trials" have been treated with extensive media coverage to demonstrate the CCP and government's decidedness to reign in abuse of office. The most spectacular case for decades involved Chongqing Party Secretary Bo Xilai, his wife Gu Kailai and Chongqing Police Chief Wang Lijun. Whereas the latter two have been put to criminal trial and sentenced, the former so far only lost his top jobs and CCP membership and is under party investigation. While Chinese official propaganda has hailed the case as proof for a functioning rule of law, the Chinese public was highly critical of the trial because the suspended death sentence for Gu Kailai for murdering the British national Neil Heywood was considered as too lenient. Foreign media reports that made their way into China over the huge personal wealth within the families of leading party cadres (especially Wen Jiabao) have shattered the stereotype that corruption does not affect the top leadership and is only a local phenomenon.

Prosecution of
office abuse
3

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 and activists are frequently persecuted. Maltreatment, physical abuse and torture of prisoners are prevalent. The country's strict birth control policy remains in place, including cases of forced abortion or forced sterilization. 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

Civil rights
2

resettlement due to large-scale governmental construction projects or illegal land grabs by local authorities violates people's property rights. Ethnic minorities are politically and economically discriminated against, as public life is dominated by Han Chinese; minority regions 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 a one-party authoritarian political system. All leading political actors are recruited from within party ranks. Other political organizations in competition with the CCP are forbidden and suppressed. There are no meaningful general elections through which the people could change the government. The judiciary is not independent; especially in "sensitive" cases involving public disturbances, state secrets or product safety, political involvement in the judicial process and in decision-making is frequent.

Performance of
democratic
institutions

1

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. Experiments with democratic selection procedures, such as primary elections, have been introduced at the township level, but are slow to progress.

Commitment to
democratic
institutions

2

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, at the CCP 18th Party Congress most recently, the upholding of one-party rule and the socialist system was highlighted while "Western-style democracy" was repudiated.

5 | Political and Social Integration

The party system is dominated by the CCP; even though a number of so-called democratic parties are officially recognized, they are subordinated to the CCP. CCP membership has grown to almost 83 million (by the end of 2011), 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. Peasants and urban industrial workers in turn have become marginalized.

Party system
1

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. The majority of interest groups has 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. 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. Some NGOs are supported by foreign donors, with the considerable danger that their agendas are shaped by the donors’ interest.

Interest groups
2

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 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.

Approval of
democracy
n/a

According to surveys, the level of interpersonal trust is extremely high in China and is almost on par with the level encountered in Scandinavian countries. Parochial trust, that is strong loyalties between family members, is particularly pronounced. 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 activists and leaders.

Social capital
5

II. Economic Transformation

6 | Level of Socioeconomic Development

Question
Score

Despite China's continuing economic growth, a large share of the population remains excluded from society due to stagnating social development and a high level of inequality. The official poverty rate increased somewhat to 13.4% in 2011, due to statistical revisions (the poverty line rose to CNY 2,300, or \$362). This brings the percentage closer to World Bank statistics, which speak of 13.1% of the population living on less than \$1.25 a day in 2008. China's HDI was 0.687 in 2011, keeping the country within the medium-development range. The overall distribution of income, as measured by the Gini index, was officially 0.474 in 2012. Independent research in China has even come up with a Gini index of 0.61 (end of 2010), which would make China one of the most unequal societies in the world. The per capita disposable income in urban/rural areas in 2012 totaled CNY 24,565/CNY 7,917 (\$3,900/\$1,257), and the urban-rural income gap of 3.1:1 only tells part of the story, as these levels do not take into account the extent of informal incomes. Living standards and a general level of development also vary considerably, with Shanghai the highest and Tibet the lowest.

Socioeconomic
barriers
5

Traditionally, Chinese women are well-integrated socially and economically, and in recent years there has been a rise in female employment and self-employment. China's GII was 0.405 in 2008 (latest available figure), ranking 38th worldwide; the country's Gender Empowerment Measure was 0.533 (2009). However, gender discrimination exists in the labor market and trends point to a worsening situation. Women's participation in politics remains limited. In 2011, while 22% of CCP members were female, women were heavily underrepresented in the top party organs (the Central Committee and the Politburo). The share of women in the NPC remained around 21.3% between 2009 and 2011. Political gender inequality is particularly

drastic in rural areas, where women occupy only 1% to 2% of the local decision-making positions.

Ethnic minorities are subject to social and economic exclusion and marginalization, with the majority of China's poor living in minority regions and 20% of non-Han Chinese counting as poor. Most prominently in the Muslim Xinjiang Uighur region and the Tibet Autonomous Regions, political marginalization, territorial infiltration by Han Chinese and economic backwardness often provoke violent resistance and lead to the formation of separatist movements.

Economic indicators		2009	2010	2011	2012
GDP	\$ M	4991256.4	5949785.7	7314432.1	8358363.1
GDP growth	%	9.2	10.4	9.3	7.8
Inflation (CPI)	%	-0.7	3.3	5.4	2.7
Unemployment	%	-	4.1	4.1	-
Foreign direct investment	% of GDP	2.6	4.1	3.8	3.0
Export growth	%	-10.3	27.7	8.8	-
Import growth	%	4.1	20.1	4.8	-
Current account balance	\$ M	243256.6	237810.4	136096.8	193139.2
Public debt	% of GDP	17.7	33.5	25.5	22.8
External debt	\$ M	443155.1	558344.1	685418.1	-
Total debt service	\$ M	39803.9	63638.2	78048.8	-
Cash surplus or deficit	% of GDP	-	-	-	-
Tax revenue	% of GDP	10.5	10.4	-	-
Government consumption	% of GDP	13.4	13.2	13.4	13.5
Public expnd. on edu.	% of GDP	-	-	-	-
Public expnd. on health	% of GDP	2.7	2.7	2.9	-
R&D expenditure	% of GDP	1.70	-	-	-
Military expenditure	% of GDP	2.2	2.1	2.0	2.0

Sources: The World Bank, World Development Indicators 2013 | International Monetary Fund (IMF), World Economic Outlook 2013 | Stockholm International Peace Research Institute (SIPRI), Military Expenditure Database 2013.

7 | Organization of the Market and Competition

Whenever China suffers inflationary pressures, the government resorts to price controls on basic goods and services. After returning to a managed floating exchange rate regime (against a basket of currencies) in June 2010, the Chinese yuan has appreciated considerably and is at the time of writing undervalued in relation to the dollar by only 5% to 20% (depending on the models used). The Chinese Central Bank allows the yuan to float against the dollar in a range of 1% per day.

Market-based
competition

6

The government in general recognizes the importance of the private sector; by the end of 2009 private enterprises generated more than half of GDP, created more than 80% of new jobs in cities and urban townships, supplied 65% of new patents and over 80% of new products. However, the legal framework for private business continues to be weak, opaque and arbitrarily implemented, and foreign business investments remain subject to government restrictions. There is no reliability of expectations as the relevant rules are frequently altered by central and local governments. Although private enterprises' market access to industries which were previously restricted, dominated by state-owned enterprises or heavily regulated (for example public utilities, financial services, national defense contractors) has been facilitated, privately owned enterprises are still often discriminated against. 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. Repatriation of profits is difficult, due to foreign exchange controls and extensive approval and implementation procedures. The government has announced that it would gradually open capital accounts over the next years and make the yuan more deliverable in offshore markets. Foreign trade through Hong Kong, settled in yuan, has increased rapidly in the last three years and accounts for nearly half of Hong Kong's trade. It is unclear, however, if this is indeed the result of trade settled in yuan or tax dodging by Chinese firms, who export and re-import goods to obtain tax breaks. The informal sector is relatively small, accounting for about 12% of the overall economy in 2007 (the most recent available data).

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 and thus eliminate local protectionism. The Ministry of Commerce (MOFCOM), National Development and Reform Commission (NDRC) and State Administration for Industry and Commerce are responsible for implementing the law. In November 2012, MOFCOM published a list of 458 merger clearances processed

Anti-monopoly
policy

7

between August 2008 and September 2012. Of this list, 90% of the parties involved at least one foreign party, suggesting that Chinese companies engaging in mergers do not comply with notification requirements. In January 2013, the NDRC imposed a substantial fine on Korean and Taiwanese liquid crystal display (LCD) manufacturers for their alleged involvement in cartel activities. Overall, due to inconsistent enforcement and implementation as well as legal insecurities for private businesses, full market-based competition in China remains stymied. Furthermore, in some strategic sectors (defense, energy production, petroleum, gas, petrochemicals, coal, civil aviation, shipping), the state upholds the existing monopolies of state-owned enterprises.

China's economic development is heavily dependent on trade; 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 rates have been lowered to 9.5% (with an average weighted tariff of 4.2%) in 2009, with many machinery and material inputs required for manufacturing tariff-exempt. China during the review period also entered into regional and bilateral free trade agreements, such as with ASEAN as of 1 January 2010 and an Economic Cooperation Framework Agreement with Taiwan that same year. However, the abolition of export barriers has been slow, and restrictions, such as prohibitions and licensing and opaque tariff classifications, are still maintained. Furthermore, regulations meant to improve freedom of trade are undermined by corruption and arbitrary administration involvement. As a means to support exports that suffered following a collapse in demand from the United States, the European Union and Japan, Chinese authorities reintroduced ad hoc measures such as interim export taxes and VAT rebates. In the period under review, filings by the United States and the European Union against China at the WTO have increased (China has retaliated by also filing against the United States and the European Union).

In general, the prevailing impression is that China benefits from free trade agreements, to the detriment of western nations.

The Chinese government has moved to improve the foundations of the banking system and introduce more market mechanisms. 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; some Western banks that purchased Chinese bank shares, however, were forced to sell them during the financial crisis to raise revenues.

Liberalization of
foreign trade

8

Banking system

6

According to official Chinese statistics, major Chinese banks, at the end of 2012, already confirmed to the Basel III capital adequacy requirement targets for 2018, and the rate of non-performing loans, at 0.95%, was low in an international perspective. However, these statistics should be approached with care, as China's Banking Regulatory Commission is not an independent watchdog (with additional banking supervision resting with the People's Bank of China and the Finance Ministry) but reports to the government, and is part of the CCP "nomenklatura" system.

Overall, foreign banks continue to play only a very small role in China's banking system, held back by remaining market constraints. The banking system is highly concentrated, with the four largest state-owned banks accounting for more than half of all assets. 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. Even though major commercial banks' asset quality, business profitability and diversification of services are still insufficient and party interference in SOCB business decisions is a daily routine, the Chinese banking system has proved remarkably resilient in the face of the financial crisis due to its closed capital accounts, the small amount of short-term external loans and its huge foreign currency reserve. Chinese banks were not exposed to risky Western financial instruments and therefore did not require a government bailout.

A remarkable trend during the review period is the decreasing role of bank lending (yuan loans) whereas non-bank lending (entrusted loans, trust loans, bank acceptance bills, corporate bonds or equity financing), often regarded as the more shadowy parts of the financial system, have increased substantially. Since borrowing by local government financial vehicles also has increased, due to new stimulus efforts in the second part of 2012, the risks in the financial system have again increased.

The financial market is still dominated by commercial banks; although institutional investors are increasing, this segment is still in its infancy.

8 | Currency and Price Stability

Volatility in China's inflation rate (as measured by the consumer price index) continued during the review period. After a deflationary period in 2009 (-0.7%), inflationary pressures increased to 3.3% in 2010 and 5.4% in 2011. Government measures to curb lending and reign in excessive real estate speculation brought inflation down in 2012 to 2.6%, while at the same time a relatively loose monetary policy (interest rates were reduced twice in 2012) was applied to reinvigorate the economy, which resulted in 7.4% growth in the third quarter of 2012. While imports rose faster than exports in 2011 (+25% versus +20%, respectively) thereby bringing the trade surplus down to \$155 billion (2.1% of GDP) in 2011, in 2012 the trend turned, with China's trade surplus increasing by almost 50% to \$231.1 billion (2.8%

Anti-inflation /
forex policy

7

of GDP). Since export earnings remained relatively flat in 2012 and foreign direct investment growth was negative at -3.7%, China's foreign currency reserves rose only slightly and stood at \$3.310 trillion or 40% of its GDP in 2012. Against the backdrop of constant criticism from the United States over an undervalued Chinese yuan, the currency appreciated significantly in 2011 but only marginally in 2012, bringing it to almost CNY 6.30 against the dollar. 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 initiated a small stimulus package in the second half of 2012, with renewed emphasis on infrastructure investments to prop up the economy, which had registered decreasing growth rates in seven consecutive quarters from the fourth quarter of 2010 to the third quarter of 2012 (down from 9.8% to 7.4%). Thus, the government managed to keep the 2012 GDP growth rate above the goal of 7.5% (7.8%, after 9.3% in 2011), although this represented the slowest yearly growth rate since 1999. The government's pro-growth fiscal and monetary measures, however, 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). Although consumption in 2012 for the first time in years contributed more to growth than investment (4 percentage points versus 3.9), the basic challenge for Chinese authorities is still the same: to maintain annual growth rates of at least 7% to 8% to guarantee an adequate number of jobs and thus avoid social unrest, while at the same time rebalancing the economy toward a more sustainable consumer-driven development path.

Macrostability
8

9 | Private Property

In October 2007, China's first private property rights law came into force. The law "protects the lawful property of individuals", that is, the property rights of private businesses, homebuyers, car owners and so on. It also aims at protecting 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. Forced resettlement caused by large-scale governmental construction projects or illegal land grabs by local authorities violate people's property rights. Disregard for intellectual property rights, theft of technology and the production and sale of counterfeit goods are widespread and inconsistently persecuted. All land ownership still remains with the state; this means there are no secure property rights for peasants. In late 2008, the CCP decided to allow peasants to lease their contracted farmland or transfer land-use rights for a fair price if they chose to migrate to an urban area. This rule also gives farmers the possibility to merge

Property rights
6

plots and employ modern farming technologies on larger fields, thereby increasing productivity and income. An important government document in early 2013 confirmed that this policy was to continue. Since the final control over land still remains with local party functionaries, the rule provides no safeguards against illegal land seizures, for example, by corrupt officials. According to estimates, up to 40 million peasants have already lost their land-use rights in this fashion and are now landless. To increase transparency and better protect peasants' land, the central government in January 2013 demanded land registers to be brought up to date within five years.

Due to murky ownership structures, hidden subsidies and various statistical indicators, it is rather impossible to draw an exact line between what is in China referred to as the "public" and "non-public sector."

However, private enterprises increasingly form the backbone of the Chinese economy; by the end of 2010 private companies made up 74% of all enterprises and employed more than 180 million people. In recent years, big private enterprises such as Lenovo, Huawei Technologies or Sany Heavy Industry have emerged as dominant 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 pressures to pay illegal fees. Since 2009, under the influence of the Chinese stimulus package, these problems have increased – leading to a saying in China, "the state advances while the private sector retreats."

The transformation of state-owned enterprises into public corporations under the maxim of "grasping the big, letting go of the small" has followed primarily a political logic and has proceeded rather slowly. Of the 114,500 state-owned enterprises, some 120 (usually big entities in strategic businesses) are directly under the auspices of the central State Asset Supervision and Administration Commission (SASAC), considerably more than the 80 to 100 that were envisaged previously. While their share in terms of industrial enterprise numbers has been shrinking to less than 3%, the state-owned enterprise share of industrial assets is still predominant, according to the National Economic Census of 2008 (which is to be updated in 2013). Most state-owned enterprises are profitable; in 2007, the central government for the first time required dividends from such enterprises, the amount of which were in January 2011 to be increased, based on the industry. In many cases, post-tax profits are not a result of the efficiency of the state-owned enterprise, but are instead owed to the enterprise's monopoly position, secured during the restructuring process. Since these monopolists are often to be found in industries which produce goods for public consumption, this situation frequently results in unnecessary high costs for consumers.

10 | Welfare Regime

Basic public social security systems covering pensions, health care, unemployment, accidents and maternal care are in place in China, but are largely geared for the urban population. The Social Insurance Law, in effect in 2011, was designed to remedy this situation. Among other points, the law strengthened the rights of migrant workers. However, as family farmers are not considered employed, unemployment insurance still only covers employees of urban enterprises and institutional organizations. Another serious problem is social security benefits for migrant workers, as many employers do not pay the necessary premiums even though they are obliged to do so by law. In addition, the transferability of earned social insurance benefits, although demanded by law, faces severe challenges in practice. Similarly, the large number of Chinese occupied in the informal sector suffers from inadequate coverage for social risks. On the positive side, a rapidly increasing number of rural poor can now claim social benefits.

According to official statistics, 459 million people were enrolled in basic pension programs (as of 2012) and 127 million urban residents were covered by unemployment insurance schemes (2009).

In April 2009, China unveiled an action plan for a radical and ambitious health care reform, aimed at attaining universal health insurance coverage by 2020, with total costs of CNY 850 billion (\$133.5 billion). According to the International Labor Organization, in 2012 China already managed to cover 95% of its population through this initiative.

However, the institutional deficits of the existing system and prevalent corruption that undermines trust in the country's broader social security systems should not be ignored. 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.

Access to education, social security and public services is secured in urban coastal regions, while the Chinese government has put forth considerable effort in recent years to spread the provision of basic services to the countryside, to western provinces and to regions with a high percentage of ethnic minorities. According to China's 2010 population census, China's male to female ratio at birth was 1.18. This ratio, which is far above the international average of 1.05, mirrors the preference of Chinese parents for male offspring. Though forbidden, many parents use prenatal diagnostics to determine the sex of their child. Female fetuses are sometimes aborted.

Social safety nets
5

Equal opportunity
5

There remains a gender gap in adult literacy. According to World Bank indicators, in 2010, 97.1% of men aged 15 and above but only 91.3% of women at the same age were literate. However, the figures for those aged 15-24 are virtually identical (99.3% female, 99.5% male), showing that this difference is a vestige of the past. In addition, as of the review period, school enrollment rates are nearly identical for both sexes.

As an official report by the All-China Women's Federation illustrated in 2012, the income gap between men and women in China has been growing. In 2010, urban women's income was 67.3% of urban men's, and rural women's income was 56% of rural men's (in 1990, by contrast, the ratios were 77.5% and 79%, respectively!).

Children who follow their migrant worker parents to the cities face great difficulties in accessing educational institutions, since their parents are often unable to pay the extra fees which are charged for migrant worker children. Some schools do not even admit migrant children. Especially in rural China, girls and women are sometimes denied equal access to health care, political participation and economic opportunity. Regarding political participation, women held 23% of the National People's Congress seats in 2013. 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. The Chinese economy registered growth rates of 9.3% in 2011 and 7.8% in 2012. Inflation reached 5.4% in 2011 and was brought down to 2.6% in 2012. GNI per capita at market exchange rates was \$4,940 in 2011 (China thus ranked 114th out of 213 countries, as listed by the World Bank). The official rate for urban unemployment was 4.1% (2011); however, RAND Corporation estimates total unemployment to be higher than 20%. In 2011, government revenue was CNY 10.37 trillion (\$1.60 trillion); total government expenditure amounted to CNY 10.89 trillion (\$1.68 trillion); the overall budgetary deficit was 1.1% and gross government debt officially stood at 25.6% of GDP, but is probably much higher as some loans by local governments and state-owned enterprises count as private debt. According to a report by Morgan Stanley, public and private debt in China combined equals more than 200% of GDP. Imports and exports totaled \$3.867 trillion in 2012 and China registered a trade surplus of \$231.1 billion (an increase of 48%). Realized incoming FDI was \$111.7 billion (-3.7%); and outbound non-financial FDI was \$77.2 billion (+28.6%) in 2012. The trend in foreign direct investment is remarkable: While the role of incoming FDI seems to be leveling off or even receding, China is emerging as an important source of outbound FDI.

Output strength
10

12 | Sustainability

In 2011, China was by far the biggest emitter of carbon dioxide, with almost 9 billion tons (as compared to the United States in the second position with 6 billion tons). Now that environmental concerns have become the main trigger for mass popular protests, even top party and government cadres have admitted that China's development path is unsustainable. This is why the Chinese government now propagates sustainable development as part of the "scientific development" concept, which is enshrined in the party statute as well as reflected in the 12th Five Year Plan (2011 – 2015). Chinese authorities claimed in January 2011 that they reached their aim to cut the country's energy consumption per unit of GDP by 20% from 2005 until 2010. There are several laws in place which deal with lean production, energy saving, renewable energies and so on, so that environmental concerns are enshrined in the institutional framework. The implementation of environmental policies however is still vastly inadequate. Due to the resistance of industries and local governments, national environmental regulations are routinely violated. Even generously funded programs such as the plan to boost "New Energy Vehicles" have run into problems because of a lack of market demand and technical issues. The State Environmental Protection Agency, upgraded to ministerial rank in March 2008 to give it more clout, is still rather toothless vis-à-vis its big administrative rivals (like the National Development and Reform Commission) or mighty state-owned enterprises.

Environmental
policy
5

As part of international climate change conferences, China has – to the chagrin of the United States and Europe – insisted that the brunt of emission reductions should be shouldered by industrialized countries and has consistently shied away from binding as well as verifiable goals. It has skillfully advocated green technology transfers to developing countries and has benefited from the Clean Development Mechanism as part of the Kyoto Protocol.

Spending on R&D as a percentage of GDP has risen from 0.6% (1995) to 1.83% (2011) but was below the official government target of 2% by the end of 2010. R&D is heavily driven by foreign companies' investments, and is dispersed unevenly across the country. In absolute terms, R&D expenditures are highest in Jiangsu, Beijing, Guangdong, Shandong and Shanghai, but in terms of R&D intensity, Beijing, Shanghai, Tianjin and, surprisingly, Shaanxi, are the leaders. In 2011, Chinese patent offices received more applications than were received in any other country. However, against 1.2 million patent applications in China stand 875 "triadic" patents (patents granted in China, Japan and Europe) held by Chinese innovators in 2010. In addition, almost one-third of all successful patent applications in China were filed by foreign actors. The number of patent applications has soared, but the success rate of patent applications by Chinese actors has continuously dropped. Thus, data from the U.N.'s World Intellectual Property Office suggest that some of the spurt in Chinese

Education policy /
R&D
8

innovation is not necessarily substantial, but rather a sign that applicants are interested in receiving Chinese subsidies.

Expenditure on education accounted for approximately 3.5% of GDP in 2011. At the National People's Congress in March 2012, the government proclaimed that it had reached its goal to spend 4% of GDP in 2012 as established in the "Medium and Long-term National Educational Reform and Development Plan (2010 – 2020)." In 2012, the education budget further increased to CNY 378 billion (\$60 billion). 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.

Transformation Management

I. Level of Difficulty

Structural constraints in China are generally on the rise, and environmental degradation risks ruining the foundations of the country's development. Natural disasters (severe floods, droughts and so on) are regular occurrences in China, which lead to considerable economic losses. China's dependence on trade and export markets poses considerable risks, as was clear in 2011 and 2012 when exports to the European Union suffered due to the euro crisis. Additionally, highly uneven regional development and a large segment of disadvantaged migrant workers endanger social stability and constrain effective governance.

Structural
constraints

6

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. However, economists generally agree that China's aging and shrinking workforce may be a drag on future economic growth. 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. With wages increasing substantially (often up to 40% per year), not least due to public mass demonstrations for a higher minimum wage, some foreign companies have already decided to leave China and relocate manufacturing centers to "cheaper" countries, such as Indonesia, Vietnam or India.

There is no robust tradition of civil society in China. NGOs and voluntary organizations have been emerging only recently. Since the state either controls or interferes with NGO work and many organizations remain particularistic or not public-focused, registered NGOs and non-registered voluntary organizations are not in the position to provide channels for popular participation or the representation of social interests. As Chinese society is group-centered, the government's recent exhortations to donate to philanthropic activities are largely ignored.

Civil society
traditions

9

While there are no irreconcilable ethnic, social or religious cleavages in China, social unrest has intensified during the review period (no official numbers have been released since after 2006). 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

Conflict intensity

5

a small, affluent group and a large, economically underprivileged group. This has increasingly led to social upheaval and has been followed by state crackdowns. After violent protests in Tibet in March 2008 and Xinjiang in 2009, the situation in both autonomous regions has become tenser; control is maintained through a massive and visible police presence in strategic locations. With a growing proportion of Tibetans and Uyghurs striving for genuine autonomy on the one hand, and the Chinese government's hard-line position on the other, chances for compromise have become increasingly unlikely. In 2011 and 2012, widespread labor strikes took place in southern China (mainly directed against Taiwanese and Japanese investors) over dismal working conditions and low minimum wages. The foreign companies promptly reacted by drastically raising minimum wages. Uncontrolled, often violent eruptions on the local level of social discontent (so-called mass incidents) over pollution, the demolition of houses and relocation or expropriation of rural land have increased in recent years, and were estimated to number between 150,000 and 180,000 in 2012.

II. Management Performance

14 | Steering Capability

The Chinese government pursues social stability and economic development as its two main priorities. Social harmony and stability are sought through more investments in rural health care and education, increasing transparency in government, the extension of elections of party officials at local levels, a dedicated policy to develop the country's western provinces, and the attempt to increase judicial fairness (if not judicial political independence). All are designed to mollify public discontent and are paralleled by a propping-up of the internal security apparatus, which now commands more official expenditures than national defense. The Chinese leadership does not aim to engage in any meaningful process of political reform or democratization of the regime.

In contrast to its often-repeated determination since 2003 to turn away from economic growth "at all costs" and to enter a more sustainable and consumer-led development path, the government again in the second half of 2012 was forced to rely on investment-led growth (especially public spending on infrastructure) and a loose monetary policy when the country's economic situation deteriorated. These measures contrasted with measures in 2011 and the first half of 2012 to deflate a property bubble and reduce inflationary pressures.

Question
Score

Prioritization
5

Overall, the government can effectively implement its main political priorities, such as upholding social stability and economic growth, even though this comes at the expense of civil liberties. Chinese authorities on the central, provincial and local levels have been successful during the review period in bringing a housing bubble and inflationary pressures under control while simultaneously propping up growth amid an adverse international economic situation (decreasing demand from the United States and Europe).

Implementation
5

The keys to economic governance still are the hierarchical channels of the Communist Party and investment planning procedures that stem from command economy times. While on the whole, in non-crisis times central government policy initiatives are often compromised or contravened by the autonomy of local officials in a highly decentralized political system (especially if their interests are infringed upon), again in the latter half of 2012 the central government and local authorities collaborated closely to turn the economy around. During the review period, the Chinese leadership did not intend nor attempt to implement any political reforms toward the democratization of the regime.

The Chinese leadership demonstrates the ability and willingness to learn from past experiences and from new sources of knowledge. However, this willingness is confined to social and economic policies, and does not extend to political reforms. 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 and environmental deterioration. 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 plays an important role in the 12th Five Year Plan (2011 – 2015). These reforms, however, face strong opposition by special interests groups (big state-owned companies and banks) which benefit from unequal access to resources and influential decision-makers, and hamper the implementation of reform measures. The Chinese leadership is not ready to accept that more pluralism and democratic reforms such as increased transparency, media freedom and public participation are required as a safeguard against this sort of undue influence and corruption.

Policy learning
5

15 | Resource Efficiency

Although there has been continuous improvement, resources are not used efficiently in the areas of civil service personnel, the budget and public administration organization. As of 2007, China employed more than 12 million people within state, party or other large government organizations, as well as maintained about 10 million civil servants, a considerable increase in the bureaucracy as compared to the 1980s and 1990s. The quality of the civil service has improved; meritocracy through competitive examinations and task-related performance appraisals has been

Efficient use of
assets
6

introduced, and the vast majority of civil servants hold university degrees. Bureaucratic professionalism and efficiency, however, is systematically 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.

China's budgetary system is highly decentralized, with local governments responsible for almost 70% 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 according to the respective provincial leader's political weight and negotiating skills. The central government seems to profit from this arrangement: the overall budgetary deficit in 2011, at -1.1%, was low when compared with other countries. On the other hand, local government debt, as reported by official data, was CNY 10.7 trillion (\$1.72 trillion) at the end of 2010, which brings the overall debt ratio higher (estimates are up to 80%) than official figures (25.8% in 2011). There is a tendency at the local level to invest in showy projects and in creating industrial overcapacity.

The Chinese government often has difficulty reconciling conflicting policy objectives and interests due to a lack of coordination and friction between national and regional/local levels of administration. These problems result from differing incentives on the central and the local level. 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 fuelling excess development in their localities to expand employment opportunities and revenues from which they gain individual political and economic profit. However, as shown in the efforts to boost the economy in the latter half of 2012, the government can increase coordination if it props up control mechanisms and if interests between local and central levels converge.

Governmental and CCP anti-corruption work is mainly limited to mass campaigns and moral exhortations and has proven largely unsuccessful. The prosecutions of individual high-profile corruption cases, in which long prison terms or even death sentences are imposed, are widely seen as a deterrence and also as evidence that the government is determined to eradicate corruption. Thus, only low-level, small-scale corruption has decreased whereas high-level, large-scale corruption continues to increase. The lack of competitive political processes, institutional checks and balances and accountability mechanisms, an independent judiciary and a free press increase the regime's susceptibility to corruption; the involvement of high-ranking political figures in corrupt activities reduces incentives for implementing serious anti-corruption measures, as has been highlighted by cases involving top-level cadres and

Policy
coordination
6

Anti-corruption
policy
4

their families in 2012. Corrupt officials and cadres more and more collaborate with local organized criminal groups. Reports posted on social media websites in 2011 and 2012 that reveal blatant cases of corruption have put authorities under increasing pressure to do more than just pay lip service to fighting corruption.

16 | Consensus-Building

There is broad consensus among Chinese leaders that the continuation of one-party rule (no democratic reforms), 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.

Consensus on goals
7

This consensus has been strengthened by the results of the 18th CCP Congress. More reform-oriented forces (such as former Guangdong party secretary Wang Yang) have not been selected to the standing committee of the Politburo, whereas leftist-populist leaders have been sidelined by the fall of Bo Xilai.

Since the late 1980s, the party leadership has been united in their opposition toward opening the political system and to enacting truly democratic reforms. Even though outgoing Premier Wen Jiabao during the review period repeatedly called for greater accountability and a strengthening of the rule of law, it remains unclear to what extent his comments reflect an actual desire for reform or rather simply a public-relations strategy to improve the government's image. In any case, Wen's position was singular and did not result in any democratic changes during the review period.

Anti-democratic actors
2

Two decades of unconstrained economic development resulted in serious social distortions and conflict between those segments of the populace 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; Chinese society is in danger of falling apart along these social fault lines. The Chinese government acknowledges the importance of equal opportunities and social justice for the nation's stability (and the CCP's hold on power) and therefore has made it a priority to spread the fruits of economic development more evenly. Although inland and western provinces have to some extent been beneficiaries of government programs, the gap between the rich and the poor, urban and rural regions have widened.

Cleavage / conflict management
6

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 policymaking by holding public hearings on pending national legislation. Today,

Civil society participation
3

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, public opinion still barely influences political decision-making, and 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. Concerning its own past, however, the government strictly prohibits all public discourse over human rights violations and does not acknowledge the responsibility of the CCP for past injustices.

Reconciliation
4

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. 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 and the solution of the Taiwan question.

Effective use of
support
7

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 (such as Gulf of Aden anti-piracy missions). 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 (at the end of 2011, China was the most important trading partner for 124 countries as compared to 70 in 2006). At the same time, traditional sources of conflict with western countries have persisted, and in some cases even intensified. Both the United States and the European Union still complain about trade deficits, market access

Credibility
7

restrictions, forced transfers of know-how and rampant violations of intellectual property rights, as well as the country's hunger for resources, drastically increasing emissions of greenhouse gases, export restrictions (particularly over rare earths) or cyber attacks on government networks and private corporations. The United States has continually criticized the undervaluation of the yuan and the hoarding of foreign exchange reserves by Beijing, and is increasingly worried about China's growing financial influence by virtue of its holding of U.S. Treasury bonds. Double-digit growth rates in defense spending have raised concerns in the United States and in regional countries to whether China's self-proclaimed "peaceful development" will be lasting.

Although trade and investment relations with its Asian neighbors continue to deepen, China in 2011 and 2012 saw its overall relationship with Japan and with ASEAN deteriorate considerably, primarily over territorial conflicts in the East China Sea (Diaoyudao/Senkaku islands) and the South China Sea (Spratly Islands, Scarborough Shoal). These issues have led to a perception of China as becoming more and more aggressive and assertive. As a result, the United States has decided to increase its presence as well as its defense cooperation with regional allies, thereby fuelling Chinese apprehension.

What's more, China during the review period increased efforts to modernize the People's Liberation Army; has commissioned an aircraft carrier (the Liaoning, stationed in Dalian); has reported maiden flights by new, fifth-generation fighter aircraft; has upgraded its conventional and nuclear missile force; and engaged in one of the more ambitious naval modernization programs in some time (introducing new classes of submarines, frigates, amphibious landing platforms and so on). As a result, the military balance in Asia has clearly shifted in favor of China.

It is only with Taiwan that the trend toward more accommodation has continued, especially since the re-election of Ma Ying-jeou in January 2012. In addition to intensifying trade and investment relations (bilateral trade and investment hit new records in 2012), both sides have set aside diplomatic competition and share the notion of the so-called consensus of 1992, where both sides agree that there is only one China, but differ in what this China actually and de jure means.

Regional
cooperation

7

Strategic Outlook

During review period, economic development and transformation in China progressed but severe structural problems and risks persisted. In quantitative terms, due to renewed stimulus measures the Chinese leadership was able to limit the effects of the economic downturn and China's importance in the world economy increased further. At the same time, the country's relatively loose monetary policy and active fiscal policy have once again shown China's dependence on fixed-asset investments and exports as the main instruments to boost growth in the short-term. Thus, the often-touted structural rebalancing of the economy toward a more consumer-led and sustainable development path again took back seat, even though some indicators point toward the slightly increasing role of domestic consumption. Given the precarious condition of local government finances, a potentially overheating real estate market, the fragile world economy and potential for a permanent situation of weak external demand, as well as the approaching end of the country's demographic dividend, the government in the coming years will have to redouble its efforts to overcome vested interests which work to dilute needed structural change.

Particularly, the government should address financial repression (interest rates that are lower than inflation rates) and inadequate social security systems. Growth must also take sustainability and energy efficiency into consideration, as China's status as the world's biggest emitter of greenhouse gases and unwillingness to cooperate with developed nations on this problem only works to increase international tensions. At home, environmental damage brought about by two decades of super-fast economic development poses a severe challenge to sustainable economic and social development. Developed nations should work hard to tightly integrate China in respective global regimes and to exact substantial commitments from the Chinese government. Ongoing commercial and non-commercial transfers of "green technology" to China will be essential for decelerating environmental degradation.

Social development also faces severe challenges, as increasing disparities in the distribution of wealth and opportunity cause social tensions and violence. The Chinese government must not only adopt measures that promote a more equitable distribution of wealth but also allow for legitimate and accountable channels through which people can seek redress. Thus, nascent elements of civil society such as NGOs, self-help groups and lawyer-activists who can support the disadvantaged should not be suppressed and intimidated but accepted by the government to enhance participation and feedback. Foreign NGOs can help by providing financial and operational support to strengthen Chinese counterpart organizations, but should refrain from imposing their own agendas.

To successfully manage short-term priorities and longer-term challenges, 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 and also threaten the efficient implementation of efforts to rebalance the economy. Since mechanisms such as a free press, an uncensored Internet and an independent judiciary are indispensable for successfully

controlling arbitrary officials and corruption, foreign governments should be less shy in explicitly demanding corresponding reforms. The necessary supportive measures should be included in governmental and private development cooperation. Since, in addition to dealing with economic crisis and transformation, the most difficult challenges to China's future lie in managing political and societal change, foreign governments and economic actors should not focus exclusively on economic aspects when dealing with China but consistently address political and social issues and offer adequate support.

In its relations with the West and its neighbors, expect a more self-confident, even assertive China that is not willing to compromise on its "core interests." With rising nationalism on all sides and China's ambition to become a "maritime great nation" (a concept highlighted at the 18th Party Congress), the conflict in the East and South China Sea could further deteriorate. Also in China's foreign economic relations more conflicts should be expected, since wide-ranging Chinese efforts to climb up the value chain will sooner or later bring it into direct competition with Western and Japanese/Korean companies (such as in consumer electronics and high-speed trains) which already complain about unfair Chinese practices. Thus, the Chinese leadership will be challenged to reconcile development imperatives at home and pressure from parts of the population (especially from nationalist groups) to defend its national interests with the need to stick to a policy of positive foreign relations and an image of a responsible great power (in the making).