1

The Challenges to China's Economic and Political Stability

Can China Build a Sustainable and Civilized Modern Economy?

We have seen in the prologue to this study that China has achieved remarkable results in its social and economic development since the process of 'reform and opening up' was initiated by Deng Xiaoping over two decades ago. However, that same process has produced a series of formidable challenges for the entire system of political economy, coming from several directions at once.

Poverty and inequality

Behind almost every aspect of China's development process in the early twenty-first century lies the harsh reality of the 'Lewis model' of economic development with unlimited supplies of labour (Lewis, 1954).

China has a huge population of almost 1.3 billion, increasing by around 15–16 million people each year (SSB, *ZTN*, 2002). From 1990 to 1999, China's working-age population rose from 679 million to 829 million, an increase of no less than 150 million in less than a decade. Almost 70 per cent of the Chinese population still lives in the countryside. Employment in agriculture is stagnant (333 million in 1995, falling to 329 million in 1999). It is estimated that there may be as many as 150 million 'surplus' farm workers. This places a powerful constraint on the rate of growth of real incomes for low-skilled occupations in the non-farm sector (see below).

As the impact of the World Trade Organization (WTO) increases, pressures on rural employment will intensify. The main alternative source of rural labour absorption, the 'township and village enterprises' (TVEs), stagnated in terms of employment creation (at around 127 million employees) after the mid-1990s. The high-speed growth of the TVEs in the 1980s and early 1990s was based mainly on the rapid growth of small businesses in labour-intensive activities using simple technologies. In order to compete within the global value chain, the TVEs are being forced to increase labour productivity fast. The thousands of new enterprises established in the early 1990s faced increasing challenges from greater market integration. The unavoidable reality is that the level of rural underemployment will continue to rise rapidly in the early years of the twenty-first century.

The farm sector is continuing to grow at around 5–6 per cent per annum, and is investing on a large scale: the total power of agricultural machinery rose from 361 million kwh in 1995 to 489 million kwh in 1999 (SSB, *ZTN*, 2002). However, there is estimated to have been a 22 per cent drop in the prices paid to farmers between 1997 and 2002. The rate of growth of farm incomes has reduced, at best, to slow progress. Official data report average annual growth of farm income per capita of around three per cent in the late 1990s. However, many analysts estimate that rural incomes have stagnated, and some argue that they have even declined since the mid-1990s. For example, Chen Xiwen, Deputy Director of the State Development Research Centre, estimates that China's farmers 'suffered an average decline in income in 1998, 1999, 2000 and 2001' (reported in *FT*, 31 October 2002). Rural income distribution has become much more unequal: the Gini coefficient of rural income distribution is estimated to have risen from 0.21 in 1978 to 0.40 in 1998. The farm sector will face severe challenges in the face of the rise in imports within the WTO, and possible deterioration in the terms of trade for farm products. One recent study believes that within the WTO in the years ahead 'the prospects for most rural households are grim' (Qu Hongbin, 2002). The share of the rural population in total consumption has fallen from around 60 per cent in the early 1980s to just 42 per cent in 2001, while the share of the rural population in China's total population still stands at 65 per cent (Qu Hongbin, 2002).

In his valedictory speech as China's Premier, Zhu Rongji warned: 'Agricultural, village and farmers' problems relate to the overall situation of China's reform, opening and modernization. We cannot neglect them or relax at any time. If we do not change these conditions, they will severely damp farmers' enthusiasm to produce, undermine the foundation of agriculture and even threaten the overall health of the national economy' (quoted in *FT*, 6 February 2003).

There is no question that there was a massive decline in absolute poverty in the early years of China's rural reforms in the late 1970s and early 1980s (Nolan, 1988). However, there still are huge numbers of people who are absolutely poor in terms of international poverty lines. Moreover, recent estimates suggest that in eight out of twenty-nine provinces, the incidence of poverty rose significantly from 1985 to 1996 (Yao Shujie, 2002). The World Bank estimated that in 1995 there were 716 million people (58 per cent of the population) who had less than US$2 per day, and around 280 million who lived on less than US$1 per day (World Bank, *WDR*, 2001: 236). A large fraction of these are rural dwellers, or rural migrants to the cities. Official data for 2001 show that the average per capita income of China's 800 million rural residents is just US$290 (RMB2,366), or 80 cents per day (SSB, *ZTN*, 2002: 343). Within the total rural population, there were approximately 580 million rural dwellers (72.5 per cent of rural households) with less than US$360 per year (SSB, *ZTN*, 2002: 343).[1] In other words, the number of absolutely poor people is still huge, and may well be growing.

The massive growth of rural underemployment deeply affects the character of development in the non-farm sector. It provides intense incentives for rural–urban migration, and great downward pressure on non-farm wages in unskilled and low-skilled occupations. By 2002, there were around 150 million rural residents who worked in the urban areas without permanent urban residence qualifications. These were predominantly 'lumpen' labour, with limited skills. The rate of pay is simple to estimate, namely the equivalent of roughly US$1–2 per day, which is the price of 'lumpen' migrant labour throughout human history (at today's prices). Even in the fastest-growing region of China, the Pearl River Delta, there was no increase in the real wages of unskilled labour during the whole of the 1990s. There is great social tension in China's urban areas, with relatively large numbers of rural migrants on subsistence wages struggling for survival alongside the rising Chinese middle class and high income earners, working mainly in the foreign sector and in Chinese businesses within the value chain of the global giant firms.

The way in which wages are determined for 'lumpen' unskilled migrant labour is basically that vividly described by John Steinbeck in the *Grapes of Wrath* (1939), on the Californian fruit farms during the Depression:

> And the migrants streamed in on the highways and their hunger was in their eyes. They had no argument, no system, nothing but their numbers and their needs. When there was work for a man, ten men fought for it – fought with a low wage – If that fella'll work for thirty cents, I'll work for twenty-five. If he'll do it for twenty-five, I'll do it for twenty. No me, I'm hungry. I'll work for fifteen. I'll work for food.

Steinbeck graphically portrays the threat to social stability posed by huge numbers of migrants:

> In the West there was panic when the migrants multiplied on the highways. Men of property were terrified for their property. Men who had never been hungry saw the eyes of the hungry. Men who had never wanted anything very much saw the flare of want in the eyes of migrants. And the men of the towns and the soft suburban country gathered to defend themselves; and they reassured themselves that they were good and the invaders bad, as a man must do before he fights. They said, These goddamed Okies are dirty and ignorant. They're degenerate, sexual maniacs. These goddamed Okies are thieves. They'll steal anything. They've got no sense of property rights. The local people whipped themselves into a mold of cruelty. Then they formed units, squads, and armed them – armed them with gas, with guns. We own the country – we can't let these Okies get out of hand.

In early 2003, it was reported that in Qingdao municipality, there was a proposal to segregate public buses, dividing them between local residents and migrant workers (*South China Morning Post*, 5 March 2003).

Social tension in the urban areas has risen sharply with changes in the pattern of urban employment. China's state-owned sector is rapidly reducing the level of employment. Wang Wei, Deputy Director of the State Council Office for Reform of the Economic System, estimates that between 1996 and 2001, 30 million workers were laid off from state-owned enterprises (quoted in *FT*, 21 November 2002). Some researchers estimate that more than 48 million people are without work as a result of reform in state-owned enterprises.

Regular employment in the urban non-state formal sector increased from 21 million in 1995 to 35 million in 1999 (SSB, *ZTN*, 2000: 115), but this is far from sufficient to absorb the large numbers made redundant from the state sector together with the swelling number of new entrants to the workforce. By 1998, the urban unemployment rate had reached over eight per cent (UNDP, 2000: 58), and is likely to accelerate as the pressure produced by China's entry to the WTO begins to bite even more deeply into employment levels in state-owned enterprises. Moreover, in order to compete within the emerging global value chain, there is intense pressures on all types of non-farm enterprises to raise labour productivity and substitute modern IT systems for people. China's 'laid-off' (*xia gang*) workers at state-owned enterprises receive greatly reduced incomes compared to that which they were supposed to receive in regular employment. In general, the standard of living of laid-off workers has greatly reduced. The early years of the twenty-first century have witnessed numerous urban strikes and protests, often on a scale unprecedented since the 1920s. Even at Daqing, where laid-off workers in China National Petroleum Corporation received exceptionally favourable terms for lay-off pay, there were large protests in the years 2000/2. The UNDP's study concluded: '[T]he explosive increase in unemployment has become the most challenging issue in China's economic and social development' (UNDP, 2000: 58).

A further element in the rising social tensions in the urban areas has been the high-speed growth of FDI from global giant multinational firms. By 2001, as noted above, the accumulated stock of FDI had reached nearly US$400 billion (UNCTAD, 2002). This investment is creating clusters of modern businesses in relatively isolated areas within China's major cities, such as the new Beijing financial district, the Pudong Development Zone and numerous 'high-technology' parks across the country. These virtual 'Treaty Ports' are emerging as areas with a relatively high degree of *de facto* autonomy, and form a nucleus of relatively high-income employment for both Chinese and foreigners, isolated from the surrounding society. A rapidly growing group of China's highest income earners live in isolated, protected compounds. One can even see in the major cities the beginning of the 'helicopter' culture that is highly developed in Brazil's main urban centres. Instead of braving the traffic nightmare, top Brazilian business people use the helicopter as their preferred mode of short-distance transport. 'Helicopter taxi services' for the Brazilian elite are a booming business. This lifts them physically and psychologically away from the normal chaotic life of the mass of urban dwellers. The nature of class differentiation in China's urban areas is changing at high speed, and in a manner that strongly recalls that of the pre-revolutionary Treaty Ports.[2]

There is strong evidence that as China has increased the pace of 'reform and opening up' since the mid-1990s, the level of urban inequality has increased substantially. Official data show that the Gini coefficient of the urban distribution of income rose from 0.25 in 1992 to 0.34 in 2001 (SSB, *ZTN*, 1993 and 2002). They show also that the income of the richest 10 per cent of the urban population rose from 3.3 times that of the poorest 10 per cent in 1992 to 5.4 times in 2001. Over the same period the income of the poorest 10 per cent fell from 57 per cent of that of the 'medium income' to 44 per cent. However, the official data do not include most of the 150 million migrants who are not registered as part of the urban population. The data also greatly underestimate the income of the highest segments of the native Chinese urban population. Nor do they include the relatively (and absolutely) large incomes of the fast-growing population of foreign employees of the multinationals. If all these factors are taken into consideration, the distribution of China's urban incomes is likely to be close to those of the most unequal countries in the world. Progressive income tax accounts for a mere 6 per cent of government income compared with 30 per cent in many parts of Asia.

There has been much discussion about the growth of the Chinese urban 'middle class'. From one perspective this appears already to be quite large. Data for 2001 (SSB, *ZTN*, 2002) show that the top decile of the urban income distribution (around 48 million people) had an average per capita income of US$1,834, and the ninth decile (another 48 million people) had around US$1,258 per capita. In a sense, we may conclude that the Chinese 'middle class' is around 90–100 million. However, this is misleading. An average per capita income of US$1,258 is on a par with the GNP per capita of such lower-middle-income countries as Ecuador or Kazakstan (World Bank, *WDR*, 2001: 274–5), while an average per capita income of US$1,834 is on a par with the GNP per capita of such lower-middle-income countries as Iran or Namibia. The top two deciles, with around 90–5 million people, are comparable in size and level of income with a medium-sized lower-middle-income country such as Egypt, with a population of 62 million and an average per capita GNP of US$1,400. The number of people in the top two deciles of the urban income distribution is comparable with a developing country such as Mexico (with a population of 97 million). However, Mexico's average per capita GNP is around US$4,400, far beyond the average per capita income of the top 20 per cent of the Chinese urban income distribution. In other words, the proportion of the Chinese urban population that is a true 'global middle class' is still extremely small, certainly a lot less than 10 per cent of the total, and, in terms of total numbers, not yet significantly developed beyond that of a single lower-middle-income, middle-sized developing country.

The average per capita income of China's total of 480 million officially registered urban residents in 2001 was just US$830, on a par with the GNP per capita of low-income countries such as Albania, Uzbekistan, Sri Lanka or Côte d'Ivoire (World Bank, *WDR*, 2001: 274–5). If we were to include the unofficial urban population of around 150 million migrant workers, then the figure would be even lower.

One recent study estimates that among China's urban households, the income of only around 20 million has caught up with the average of the urban households in East Asia's Newly Industrializing Countries (Qu Hongbin, 2002). This amounts to only around 12 per cent of the total number of officially registered urban households, and a significantly smaller proportion of the total number of urban households. The study estimates that, if present growth rates continue, another 20 million 'global middle-class households' will emerge in China in the next decade. This is likely to still be less than one-fifth of the total number of urban households in ten years' time. In other words, China's emerging middle class, those who can afford, for example, to buy automobiles, will remain a 'besieged' minority among a sea of urban poor people, who vastly outnumber them: the twenty-first century meets the eighteenth century at the window of Starbucks. The vast majority of the urban population are excluded by their low incomes from Starbucks or Walmart and excluded by armed guards from the apartment blocks of the new middle class, except where they are employed for domestic service.

The privatization process in China to date has been characterized by widespread insider dealing and corruption. In the years ahead there is a prospect that as much as RMB10 trillion (around US$1.2 trillion) in government assets will be privatized (Qu Hongbin, 2002). The way in which the transfer of such a huge volume of assets takes place will have substantial implications for the distribution of wealth. One study that is optimistic as to the benefits of forthcoming privatization nevertheless warns: 'Privatization will benefit everyone, but the privileged classes are likely to find ways of further enriching themselves' (Qu Hongbin, 2002). Another recent study of mainland bank deposits estimates that just 0.16 per cent of the population controls 65 per cent of the nation's US$1.5 trillion liquid assets. Compared with the rest of Asia, China reportedly has the highest concentration of wealth in the fewest hands, with a very narrow group of just two to three million people able to 'get rich quickly' (*South China Morning Post*, 29 March 2003).

There is wide concern among Chinese policy-makers about the implications of these trends for social stability in the urban areas. Intense official research efforts have been devoted to analysing trends in social inequality and trying to understand their ramifications, as well as to creating policies to ameliorate the rising tide of inequality. Many analysts believe that the reform process has entered a tense period in which there is an increased danger of social instability compared with the previous twenty years. There has been extensive discussion among policy-makers about how to build a dynamic economy while 'laying the groundwork for a market that is moral and fair', thus sustaining China as a 'steady and harmonious society' and, in the vision of its leaders, an 'everlasting and peaceful nation'.

The global business revolution

A consistently stated goal of China's industrial policy has been to construct globally powerful companies that can compete on the global level playing field:

> In our world today economic competition between nations is in fact between each nation's large enterprises and enterprise groups. A nation's economic might is concentrated and manifested in the economic power and international competitiveness of its large enterprises and groups. International economic confrontations in reality show that if a country has several large enterprises or groups it will be able to maintain a certain market share and hold an assured position in the world economic order. . . . *In the same way now and in the next century our nation's position in the international economic order will be to a large extent determined by the position of our nation's large enterprises and groups*. (Wu Bangguo, Chinese State Council, quoted in *Jingji Ribao* [*Economic Daily*], 1 August 1998, emphasis added)

In pursuit of this objective, China's stated goal of industrial policy has been to construct a sizeable group of large-scale powerful industrial firms that can challenge the global leaders. The chosen corporations were supported through a sequence of industrial policies.[3] China's planners carefully studied the industrial policies used by the high-income economies in their early stages of development. From Britain during the Industrial Revolution, the US and Continental Europe in the nineteenth century, through to the East Asian 'Tiger' economies of the late twentieth century, almost without exception, late-industrializing countries used some form of industrial policy to nurture 'national champions'. Each of these late-industrializing countries was able through different methods to nurture a group of globally competitive large firms.

The most powerful influence on the thinking of China's policy-makers was probably the Japanese experience. During a similar period in Japan's development, from the 1950s to the 1970s, Japan's industrial planners supported the growth of a series of giant companies that developed into globally powerful firms. In many sectors the state nurtured just two or three dominant firms that were in an oligopolistic position in the domestic market. After two decades of industrial policy, there was a whole corps of globally competitive Japanese companies. By the late 1980s, Japan had twenty of the largest one hundred corporations in the *Fortune* 500 list. These companies developed through extensive support from state industrial policies, very similar to those adopted by China forty years later.[4]

How capable are China's 'national champions' to compete on the 'global level playing field' within the WTO? In the course of the 'China Big Business Programme', we tried to answer this question, using detailed case studies from China's 'national team' in several different sectors (Nolan, 2001a, 2001b). These include aerospace, pharmaceuticals, oil and petrochemicals, power equipment, automobiles and components, steel and coal, consumer electronics, telecommunications, IT hardware and financial services. In each case we found evidence of progress, but with many problems remaining. Moreover, in each case the reform within China was taking place against a background of revolutionary global change. The micro-level evidence from our case studies suggests that in most key respects, China's industrial policies of the 1980s and 1990s did not succeed.

The aggregate data confirm this view. At the start of the twenty-first century, not one of China's leading enterprises had become a globally competitive giant corporation, with a global market, a global brand and a global procurement system. The Chinese companies included in the *Fortune* 500 all faced huge problems of downsizing. China had no less than six of the top ten companies in the *Fortune* 500 in terms of numbers of employees, a dubious achievement. Every one of China's *Fortune* 500 companies was predominantly or wholly a state-owned firm, operating with a high degree of state protection. China has just three companies in the *FT* 500, which ranks firms by market capitalization. These are CNOOC (China National Offshore Oil Company), China Mobile and China Unicom, each of which operates in a totally protected domestic environment. Moreover, the vast bulk of the IT hardware equipment for China's telecoms companies is purchased from the global giants.[5] China does not have a single company in the world's top 300 companies by R&D expenditure. Nor does it have any representatives in Morgan Stanley Dean Witter's list of the world's top 250 'competitive edge' companies, or a single company in *Business Week*'s list of the world's top 100 brands.

The blunt reality is that after two decades of reform China's large firms are still far from being able to compete with the global giants. The gap is especially marked in the high-technology sectors, such as aerospace, power equipment, IT hardware and pharmaceuticals. It is marked even in 'mid-technology' sectors such as oil and petrochemicals, auto assembly and auto components. Even in sectors with apparently less advanced technology, such as steel, coal and consumer electrical equipment, there is a significant gap compared to leading global companies in the high value-added segments of the market. The challenge is not confined to the manufacturing sector. China's four main banks lag far behind the global giants in almost all respects. They will face an intense battle to compete as the WTO rules come into effect. It is thought likely that at least two of the big four domestic banks will be split up into many smaller pieces.

By the simplest of measures of sales revenue, profits and R&D, China's vanguard of leading firms that are intended to 'compete on the global level playing field' are still far behind the global leaders. Indeed, if we look across the whole spectrum of industries, it may even be the case that China's leading firms are further behind the global leaders than they were when the industrial policies began almost two decades ago. In these fundamental senses, China's industrial policy of the past two decades must be judged a failure. The reasons are both internal and external.

On the internal front, China's industrial policy encountered a number of peculiar problems which substantially differentiate the Chinese policy environment from that which faced Japan and Korea during their comparable period of catch-up at the level of the large firm. Within the same industry, radically different policies have been pursued at different times.[6] In addition, completely different policies were pursued in different sectors.[7] The foundation of China's economic reform was to increase 'enterprise' autonomy. The core of most large 'enterprises' was a single large production unit. This had many benefits, including the development of a strong sense of corporate ambition at the enterprise level. However, it caused difficulties in the subsequent attempts to build multi-plant firms with unified central control over individual production units. China is still a poor country, with a relatively tiny middle class. A large fraction of domestic demand is for low-price, low value-added products. Large Chinese firms have to fight a battle on two fronts: on the one hand with global giants in high value-added products, and, on the other hand, with domestic small and medium-sized enterprises in low value-added products.

China has a tradition of relatively autonomous local government. There has been persistent local resistance to cross-regional mergers due to fears of downsizing and loss of control of a 'local asset'. Unlike the other 'late-comer' countries, China's large enterprises inherited huge manning levels, which are hard to reduce without causing social instability. This will remain a deep problem for many years. The inability of China's emerging large firms to compete on international markets, plus the fact that they each have a huge workforce, produced a high incentive for the individual enterprise to diversify. A single large enterprise could easily have hundreds of 'children' and 'grandchildren' subsidiaries and related companies. This gives the 'illusion of scale', but beneath an apparently large firm there are typically hundreds of uneconomically small firms and immense problems of corporate governance. The weaknesses of such East Asian diversified 'network' firms were starkly revealed by the Asian Financial Crisis, which dealt a comprehensive blow to the dream that they could compete on the 'global level playing field'.

China's bureaucracy, meanwhile, has lacked the powerful nationalist incentive to build large firms successfully that drove Japanese (and Korean) policy-makers, and its ability to implement industrial policy purposefully and successfully has been undermined by deep-rooted corruption. The country's leaders are engaged in an intensive drive to solve this problem, repeatedly emphasizing that this is crucial to the maintenance of system stability (see pp. 39–44 below). Many of the worst examples of corruption have been exposed in the financial services sector, which is at the heart of the Chinese economy and the whole reform process. For most of the reform period the commitment to state ownership remained a goal in its own right, rather than building powerful corporations by whatever means was suitable. It proved hard to achieve the essential separation of government and enterprise.

On the external front, the period in which China has attempted to build strong indigenous firms through industrial policy has been quite different from that of the East Asian Newly Industrializing Countries at a similar phase in their development. The global business system was much more stable during the period during which Japan, South

Korea and Taiwan were putting into place their industrial policy. Moreover, the high-income countries were willing to tolerate extensive state intervention in the NICs, because they were viewed as the front line in the fight against communism. By contrast, China's attempt to build large globally competitive firms coincided with the most revolutionary epoch in world business history, possibly even including the Industrial Revolution. Moreover, the country is regarded by the USA as a 'strategic competitor'.

There are a number of aspects to the global business revolution. The period since the late 1980s has witnessed for the first time the opening up of a truly global marketplace in goods, services, capital and highly skilled labour. The only market which still remains bound firmly by nationality is the vast sea of unskilled labour. There is no chance for the surging mass of China's hundreds of millions of rural underemployed workers to find employment outside China. The world's leading firms have massively increased their production capabilities in fast-growing parts of developing countries. Of course, large swathes of the developing world have been hardly touched by the forces of globalization. Nevertheless, the struggle among the world's oligopolistic firms has now deeply penetrated the most developed parts of the low- and middle-income countries. The total stock of FDI in developing countries rose from US$344 billion in 1985 to US$2,181 billion in 2001 (UNCTAD, 2002). China was the main single focus of attention, with the stock of FDI rising from US$25 billion in 1990 to US$395 billion in 2001.[8] This period was the world's most explosive period of mergers and acquisitions. The size of the merger boom of the 1990s eclipses that of any previous epoch, and will leave a long-lasting imprint on the global business structure. In almost every sector a small number of focused global producers dominate the world market. Competitive capitalism's in-built tendency to concentration and oligopoly, which is vigorously denied by both free market economists and the leaders of large corporations, has finally flowered on a global scale. There appears to be a near-universal rule that the top four to six companies (sometimes even fewer) control around 50 to 75 per cent of the entire global market, while large numbers of small and medium-sized firms fight for the 'niche' positions within local markets, typically confined to the low value-added parts of the market supplying the needs of poor people.

At the centre of each sector of the economy stand a small group of core firms which integrate the whole supply chain for their products. Not only have these core 'systems-integrator' firms experienced an explosive process of concentration, the deepening interaction between core companies and supplier companies has also created an explosive 'cascade' effect that is rapidly leading to concentration and focus among the first-tier suppliers and spilling over even into second- and third-tier suppliers. Concentration among leading aircraft assemblers, for example, has stimulated concentration among the main aerospace components suppliers: there are now just three makers of large aircraft engines across the world. Concentration among auto assemblers has stimulated concentration among auto components makers: the top three tyre makers account for almost two-thirds of global output. In sector after sector, the 'first-tier' suppliers are themselves multi-billion dollar companies with 'global reach'. Through the hugely increased planning function undertaken by systems-integrators, facilitated by recent developments in information technology, the boundaries of the large corporation have become blurred. In order to develop and maintain their competitive advantage, the systems-integrators deeply penetrate the value chain both upstream and downstream. They are closely involved in business activities that range from long-term planning to meticulous control of day-to-day production and delivery schedules. Competitive advantage for the systems-integrator requires that it must consider the interests of the whole value chain in order to minimize costs across the whole system. Far from becoming 'hollowed out' and much smaller in scope, the extent of control exercised by the large firm has enormously increased during the global business revolution.

Regions containing a small fraction of the world's population have massively dominated the global business revolution. The high-income economies contain just 16 per cent of the world's total population. They account for 91 per cent of the world's total stock market capitalization, 95 per cent of *Fortune* 500 companies, 97 per cent of the *FT* 500 companies, 99 per cent of the world's top 300 companies by value of R&D spending and 99 per cent of the world's top brands. North America is, by far, the world leader in this process. It has just over 5 per cent of the world's population, but accounts for 40 per cent of the *Fortune* 500 firms, 46 per cent of the world's top 300 firms by R&D expenditure (74 per cent of the top 300 IT hardware and software firms, ranked by R&D spending), 50 per cent of the *FT* 500 firms, 54 per cent of Morgan Stanley Dean Witter's list of the top 250 'global competitive edge' firms and 61 per cent of the world's top 100 brands.

Developing countries are massively disadvantaged in the race to compete on the 'global level playing field' of international big business. The starting points in the race to dominate global markets could not be more uneven. The whole of the developing world, containing 84 per cent of the world's population, contains just twenty-six *Fortune* 500 companies, sixteen *FT* 500 companies, fifteen of Morgan Stanley Dean Witter's list of the 250 leading 'competitive edge' companies, one of the world's top 100 brands and none of the world's top 300 companies by R&D expenditure.

China's rapid move towards 'close' integration with the world economy is occurring at a time of revolutionary change in the global business system. Large Chinese firms are far from ready to compete on the 'global level playing field'. This presents an extreme challenge for China's industrial strategy. Privatization of China's large enterprises will not be sufficient to make them globally competitive. If China's firms cannot generally compete at the level of 'systems-integrator', it is hard to see either how in most industries they will be able to compete at the level of first-tier supplier. For a substantial period ahead, China will have to accept that, under the terms of the WTO Agreement, its best hope is to be a 'workshop' for the rest of the world,[9] housing the production facilities for the global giant firms and the leading parts of their supply chain, headquartered in the high-income countries. China's entry to the WTO greatly reduces the scope for industrial policy.

Conclusion

China is becoming increasingly 'dependent' in the classical sense used by the Latin American economists in the 1950s (Frank, 1967). In every case, successful late-comer industrializing countries, from the USA in the late nineteenth century to South Korea in the late twentieth century, have produced a group of globally competitive firms. China is the first successful late-comer not to have done so. It is remarkable that China has reached a position in which it is the world's sixth largest economy[10] without having a group of internationally competitive large firms. This is highly significant in the history of economic development. Already, over 30 per cent of industrial profits, and one-half of China's export earnings, are generated by foreign-invested firms.[11] If the 'bubble' of foreign direct investment in China were to burst, it would have serious consequences for the whole growth path and for China's stability. There is intense debate at all levels of Chinese society about the significance of this phenomenon. Many popular books and articles characterize China's development path as 'neo-colonial', drawing comparisons with the dependent nature of Chinese economic development from the mid-nineteenth century until 1949.

This situation presents a big challenge for China's policy-makers. We have noted the great difference between China's situation in terms of the international competitive challenge, and that of all previous 'late-comer' countries. It faces far greater global industrial concentration and competition than any previous late-comer country. In terms of military analogy, we may say that China's industrial policy has increasingly followed the dictum of Sun Zi's (Sun Wu) *Art of War*: 'If the enemy forces outnumber yours, retreat; if your forces are weaker in strength, avoid a decisive engagement' (Sun Wu, 1996: 33).

Given the drastic inequality in competitive power between its own firms and the global leaders, China has to find a different strategy from that adopted by other late-comer countries:

> New victories are not achieved by putting on old plays. The variations of the military tactics in accordance with the changing circumstances know no end. . . . There are no fixed forms or inflexible rules in military tactics. Only those who are able to vary their tactics according to the changing manoeuvre of the enemy and win victories have really miraculous skill. (Sun Wu, 1996: 61)

Even in large-scale 'retreat', even with important parts of the 'army' giving up the struggle and moving into the opposing camp, there are still strategies that a determined group of 'generals' can employ as long as they are clear where they are going.

The modern global corporation may be weaker than it appears. Despite their massive business capability, the global giants are encountering a period of high turbulence. They are mired in deep difficulties in terms of corporate governance and face huge cumulative difficulties arising from the collapse of the stock market. This drastically limits their ability to undertake mergers and acquisitions. It has placed enormous burdens upon their balance sheets due to the collapse in the value of their pension funds, and the massive increase in pension fund contributions that they are being forced to make. This eats deeply into their funds available for expansion. While the economists of the high-income countries ridiculed the 'cross-investments' among Japanese *keiretsu*, they had ignored the vast 'cross-investments' among themselves which arose as a consequence of the pension funds. The US economy is able to grow substantially mainly due to the support given to the US consumer through the massive flow of capital into the country, principally from East Asia. If this flow were to be reversed, and the dollar to collapse, the prospects for the US economy and US business would be even further impaired.

The economic impact of the USA's sharp turn towards a unilateral, aggressive foreign policy in the wake of 11 September is highly unpredictable, with massive potential consequence for the federal budget.

It is even possible that the high point of the US's economic and military power may already have passed; its 'prime' may already be over: 'Win the war, but do not boast; win the war, but do not show arrogance; whatever is in its prime is bound to decline, for, being in the prime goes against the *Dao*; whatever goes against the *Dao* will come to an early end' (from Lao Zi, 1995: 149–51).

The global corporation is in only the early days of its formation, whereas the nation state is far more robust and long-lived. The global corporation 'has no lasting social and political purpose': 'The only purpose of the average firm is to produce wealth for the shareholders; shareholders whose wealth is readily migrant and who can invest in infinite places' (Scott, 2001: 16). In terms of the strategies employed by Sun Zi, the rapid rise of FDI in China, dominating the local market in a wide range of products, can be viewed as ceding territory to the enemy: 'An experienced commander entices the enemy into going where he wishes them to be and prevents them from reaching their objective' (Sun Wu, 1996: 58). The rapid rise of Chinese people employed within the global corporation, gradually 'Sinifying' it, can be compared to the 'espionage agents' in Sun Zi:

> No-one in the army deserves a closer attention, higher rewards or deeper secrecy than the agents. . . . If all five kinds of agents are employed,[12] and the enemy cannot find out the patterns of their activities, then a magical power could be produced which is surely an incomparable treasure for the ruler. . . . Espionage is omnipresent; it stops at nothing; it is practically everywhere. (Sun Wu, 1996: 128)

The key for Sun Zi is strategy:

> Skillful military leaders conquer the enemy without fighting battles, capture cities without attacking them and overcome States without protracted warfare. They strive for supremacy without stationing their troops abroad, yet they win complete victory over their enemies. (Sun Wu, 1996: 33)

However, in the end it is the proficiency of the 'generals' that is the critical issue:

> Generals are guardians of the State. Their proficiency in warfare makes the State strong, their deficiency makes the State weak. (Sun Wu, 1996: 33)

To devise a strategy to deal with today's overwhelming imbalance in business power requires 'generals' of great skill and leadership ability.

The environment

China's environmental deterioration presents a further deep challenge for the state. This reflects the intense pressure of a huge and growing population upon the country's already fragile natural environment, with the impact hugely reinforced by high-speed industrial growth.

The area affected by serious soil erosion has increased to include around 38 per cent of the entire country (UNDP, 2000: 70). The area of desert is increasing at the rate of around 2,500 square kilometres per year, equivalent to the area of a medium-sized country. In the past four decades, almost one-half of China's forests have been destroyed, so that it now has one of the sparsest forest covers in the world. There is a serious and worsening shortage of fresh water, and 'rampant water pollution' is making the situation worse. The capacity to protect the environment has lagged seriously behind the speed of destruction: 'Thus, environmental quality continues to worsen and this has evolved into the most severe, large-scale and profound ecological destruction in Chinese history' (UNDP, 2000: 70).

China's explosive industrial growth has led to high-speed expansion of energy-intensive industries. By the late 1990s, these accounted for around 36 per cent of the country's manufacturing value-added, compared with just 23 per cent in Japan and 21 per cent in the USA (Nolan, 2001a: 700). China has a relatively limited amount of oil and gas, but has huge reserves of coal. By the mid-1990s, China had overtaken the USA as the world's biggest coal producer, accounting for almost 30 per cent of global output. Coal provides a low-cost way to meet a large fraction of China's booming demands for energy to meet the needs of the country's 'industrial revolution'. In the late 1990s, coal supplied the primary energy for around 70 per cent of the country's electricity supply (Nolan, 2001a: 699).

In the advanced economies, burning coal on open fires and in old-fashioned power stations was responsible for large amounts of atmospheric pollution through the generation of airborne particulates. Not until the 1950s did serious efforts get under way to improve the quality of the atmosphere consequent upon using coal as a main source of primary energy. Both government legislation and the demands of shareholders forced large changes in the way coal was mined, transported and used. Reclamation and rehabilitation work is now a central part of mine development. Coal is prepared, stockpiled and transported in a much more careful way: for example, it is washed, stockpiles are sprayed and it is covered in transport. The use of coal on open domestic fires and in primitive industrial boilers has been reduced drastically. The almost universal use of precipitators and filters means that power stations no longer emit large quantities of black smoke and dust, which were the primary cause of pollution. However, all these measures to ameliorate the environmental effects of coal use require appropriate legislation and enforcement, and involve high costs.

By contrast, in China, the ways in which coal is mined, transported and used as a fuel approximate those of the advanced economies before the 1950s. Large quantities of coal are mined and stored with little care for the environmental impact of mining operations. Coal is mostly transported unwashed and uncovered. Large quantities of high-sulphur coal are used. Huge amounts of coal are burned on open fires and in primitive boilers. This has caused a huge burden of air pollution, which is 'not surprising in a nation where combustion of one billion tons of coal, largely uncleaned and burned with minimal or no air pollution controls, supplies three-quarters of all primary energy' (Smil, 1993: 117). The recommended maximum daily mean total for suspended particulates is no more than 300 micrograms per cubic metre. In fact, in northern China in the early 1990s, the levels were commonly as high as 500–1,000 micrograms per cubic metre, and on the worst days reached as high as 2,000 (Smil, 1993: 117). Daily means of sulphur dioxide concentration in North America have now fallen to around 20–100 micrograms per cubic metre. In China in the 1990s, they were commonly between 100 and 400 micrograms per cubic metre, and regularly surpassed 600 micrograms in the heating season, sometimes reaching as high as 2,000 micrograms (Smil, 1993: 117).

Total discharges of particulate matter are officially reported to have reached 15 million tons by the 1990s, and are unofficially estimated to have reached 20 million tons (Smil, 1993: 117–18). Even the official figures show China as producing 15 per cent of the global total of 100 million tons, of which around two-thirds is generated by coal combustion (Smil, 1993: 118). China's share of global carbon dioxide emissions rose from 10.8 per cent in 1980 to 14.9 per cent in 1996, and in the not-too-distant future China should overtake the USA as the world's largest producer of carbon dioxide (the USA's share currently stands at 23.4 per cent) (World Bank, *WDR*, 2000: 248–9).

In addition to the production of particulates and carbon dioxide, coal-burning involves the production of sulphur dioxide, which produces acid rain. Despite very high levels of sulphur dioxide in the atmosphere, North China has only low levels of acid rain. This is due to the large amounts of calcium, potassium and magnesium compounds in the atmosphere. These neutralize the emitted sulphur dioxide. However, South China has serious problems of acid rain, caused mainly by burning coal with high sulphur content. Much of the sulphur could be eliminated through washing, but only around 10 per cent of China's high-sulphur coal is washed (Smil, 1993: 118). Sulphur dioxide is especially expensive to control: 'Until very recently even many rich countries avoided this costly commitment' (Smil, 1993: 121). Indeed, Smil estimates that the capital cost of installing desulphurization facilities increases the cost of electricity by 25–30 per cent, and operating costs 'add a similar mark-up to the electricity generation cost' (Smil, 1993: 235).

China's leaders are fully aware of the damage that large-scale consumption of coal does to the country's environment and to public health. At the 1999 annual session of the Chinese National People's Congress, Premier Zhu Rongji recognized that 'the deterioration of the ecological environment remains a glaring problem', and pledged to 'improve the air quality in the capital and punish polluting enterprises' (quoted in the *FT*, 6 March 1999). However, there are powerful economic pressures for continued increases in the consumption of coal.[13]

The implications of China's mode of industrialization are of the greatest importance for the physical sustainability of life on this planet. Already, in addition to high and rising levels of particulates in the air, China is now the world's second largest producer of 'greenhouse gases' after the USA. Its commercial energy use (1,113 million metric tons of oil equivalent) is already over one-half that of the USA (2,162 million) (World Bank, *WDR*, 2001: 292–3). If China follows the US free market approach to industrialization, allowing, for example, complete dominance to the automobile, then the prospects for the world are terrifying. If China's 1.4 billion people were to sustain their current growth path and at some point catch up with today's US level of per capita income, and were to use similar technologies, the country's use of commercial energy and emission of carbon dioxide would be one-fifth greater than those of the entire world today.

One of the deepest threats to the Chinese environment has come from the combination of forces (population growth, industrial growth, agricultural intensification and climate change) that has reduced the flow of the Yellow River to a mere trickle for long periods of the year (see Wang Xiaoqiang et al., 1999). In an attempt to deal with the crisis the central government has initiated a massive scheme to transfer water from the south to the north along two or three separate routes to feed into the Yellow River. This is estimated to require investment much in excess of the US$24 billion that was needed to build the Three Gorges Dam. It will rival the great ancient long-distance waterways constructed in Chinese history, notably the Grand Canal. Like other large-scale water conservancy projects, the finance is to be raised through a combination of central and local budgets, bank loans, international funds and user fees. It is expected that the unit price of water used as a result of the scheme will be considerably higher than current water charges.[14]

Whatever combination of measures is adopted, involving more or less use of the price mechanism to achieve the hoped-for results, the Chinese state will be central to the country's ability to achieve environmentally sustainable development.

The capability and role of the state

The reform period in China has been accompanied by great changes in the function of the state, including a drastic reduction in direct state instructions. However, as we have seen, China is a vast, poor country with urgent development needs, many of which can only be met by state action of one sort or another. During the reform period, the state's fiscal capacity has sharply declined. The share of budget revenue in GDP fell from over 31 per cent in 1979 to a low of just 10.7 per cent in 1995 (SSB, *ZTN*, 2001: 256). This was far below that for most high-income countries. In 1997, tax revenue as a proportion of GDP stood at over 30 per cent in all Western European countries, and as high as 43 per cent in Belgium and the Netherlands (World Bank, *WDR*, 2001: 256–7). The USA stands out strikingly against this pattern, with tax revenues in 1997 accounting for just 20 per cent of GDP, but still substantially above those for China. By the late 1990s, the share of government revenue in GDP was not only below that of many developing countries, such as Indonesia and Malaysia, but was also below that of Russia, which is widely perceived as having experienced 'state desertion' during the reform period. In these terms, one can say that China's level of 'state desertion' during the 'transition' period outstripped even that of Russia, leading the UNDP to comment: 'The decline of the state's fiscal role and position has gravely undermined the [Chinese] government's capacity to promote economic development' (UNDP, 2000: 41).

In the critically important health and education sectors, the state's reduced fiscal strength has forced it to look for drastically increased contributions from fees paid by people when they use the services (see below). However, its weakened fiscal capability has had other more immediate dangers for social stability. In order to dampen the impact of large-scale lay-offs, the Chinese government has been trying for many years to develop a comprehensive social security system. However, this programme had made very limited progress by the end of the 1990s. The transitional needs of these programmes are large. While they are being established, they require a large infusion of government funds, but the state's fiscal weakness has made this impossible (UNDP, 2000: 76).

The government is well aware of the need to increase its fiscal strength in order to undertake the wide range of activities necessary to meet the numerous areas of market failure. Recognizing the key function of the state in supporting public goods provision, the Chinese state attempted to increase its fiscal strength after the mid-1990s, with a series of important reforms. However, even in 1999 the proportion of government revenue in GDP still stood at only 14 per cent, which greatly inhibited its ability to provide public goods on the scale required by China's urgent development needs.

An unusually high proportion of state expenditure takes place at the local level. The share of the localities in total state budgetary outlays was already high in the late 1970s, but has increased still further during the reform period. By the late 1990s, the localities accounted for 64 per cent of total budgetary expenditure (World Bank, 2002: 31). The responsibilities of the localities are especially high in relation to social welfare spending. In the late 1990s, the localities accounted for 89 per cent of total budgetary expenditure on culture, education and health (World Bank, 2002: 31). The lowest level of public administration, the counties and townships, account for fully 70 per cent of the country's total budgetary outlays on education and 55–60 per cent on health (World Bank, 2002: ii). However, after the reform of the public finance system in 1994, the local governments' share of total revenue fell to less than one-half of the country's total (World Bank, 2002: 16). The transfers from the central government to the local governments were conducted through a 'complex and befuddling system' (World Bank, 2002: 17). The net result was that the local governments were increasingly left to their own devices to fund their expenditure, and faced a serious 'fiscal squeeze' (World Bank, 2002: 36).

The 'pushing down' of a large fraction of expenditure responsibility to the township level has 'forced the rural sector to "tax" itself through fees or community contributions to cover the cost of provision' (World Bank, 2002: 42). By the end of the 1990s, budgetary allocations covered just 46 per cent of actual expenditures on education (World Bank, 2002: 85). A wide variety of other sources of funding have been mobilized to finance education, including surcharges, fees collected from students, revenues from school-run enterprises, work study programmes, donations and gifts.

The outcome of the increasing use of the market to provide educational services has been 'growing disparities in per capita [education] expenditure across regions, both inter-provincial and intra-provincial': 'What is of particular worry is that . . . the low end is not improving despite the efforts [made] to raise the minimum provision of education in poor regions' (World Bank, 2002: 101). There appear to be 'significant gaps between the stated national goals and the actual provision of education and health services in poor regions' (World Bank, 2002: 42). A large-scale rural household survey found that between the late 1980s and mid-1990s, there was 'a substantial deterioration in the educational status of the poor' (World Bank, 2002: 42). The survey showed that among 'poor' people, between 1988 and 1995 the proportion who had completed five years of schooling fell from 68 per cent to 53 per cent in non-poor regions and from 54 per cent to 42 per cent in poor regions (World Bank, 2002: 43).

Over the past five decades, China has built an impressive rural health system, and overall health achievements are impressive, with a life expectancy of seventy and an infant mortality rate of 31 per 1,000 live births. At the peak of the rural people's communes before 1976, around 85 per cent of villages had a co-operative medical system, albeit often rudimentary (World Bank, 2002: 116). The economic reforms led to a large increase in average personal income. This facilitated substantial increases in household expenditure on health, and much improved diet and nutritional status for the average Chinese person.

When the agricultural collectives were disbanded in the early 1980s, the financial basis for risk-sharing was largely eliminated, except in the coastal areas, where prosperous township and village enterprises continued to generate substantial resources belonging to the collective. However, poor areas lacked such collective resources, and in rich areas, there has been widespread *de facto* or *de jure* privatization of collective enterprises. The World Bank estimates that at the end of the 1990s, more than 90 per cent of the rural population, or 700 million people, were without any coverage from collective risk-pooling schemes (World Bank, 2002: 116).

Each level of government largely finances its own health facilities. This means that the quality of health services in each locality is highly dependent on the financial health of the local budget (World Bank, 2002: 118). The World Bank estimates that in 1999, the government budget funded just 11 per cent of total health expenditure, while 59 per cent came from out-of-pocket payments. Among poor people, the shift in the nature of health service provision has resulted in large real increases in private payments for health care. One study estimates that the share of poor households' income allocated to medical expenses rose from less than 1.5 per cent in 1988, to 5.6 per cent in 1995 (World Bank, 2002: 43).

These changes have resulted in a system that provides highly unequal access to health services. The *World Health Report*, 2000, ranked China 61st out of 191 countries in overall quality of health, but 188th in terms of fairness in financial contribution (quoted in World Bank, 2002: iv).

The crisis in the rural health system caused deep concern among China's leaders about the decline in preventive medicine, and, especially, the ability to halt the spread of infectious diseases. In October 2002, the central government announced an ambitious plan to create a new rural collective medical system. However, no sooner had this initiative been announced than the country was plunged into the SARS crisis. In the event, SARS was largely contained in the urban areas and the rural areas were not heavily challenged by it.

International relations

By the end of the 1990s, there were several threats to China's sociopolitical stability. In key respects they greatly exceeded the difficulties facing other developing countries. Like India and Indonesia, China faced a special challenge in attempting to prevent the separatist tendencies inherent in a large country with wide racial, cultural and religious differences. Unlike those giant countries, China is still ruled by the Communist Party, whose ideology is hostile in principle to free market capitalism. China's highly successful development policies since the late 1970s have produced a powerful economy that is viewed as becoming a serious potential rival for the dominant world power, the USA, within a relatively short period of time. Those who wish to emphasize the size of the Chinese 'challenge' point to the fact that, measured in 'purchasing power parity' (PPP) dollars (essentially using the prices of the USA), China is already the world's second largest economy, 36 per cent larger than Japan, and over one-half the size of the USA (World Bank, *WDR*, 2001: 230–1). Even if one disregards the PPP figures, it is indisputable that, if China maintains its high growth rate, at some point in the not-too-distant future it will, indeed, become a serious challenger to the USA's dominant position. Therefore, unlike the other large developing countries, China's must face the reality that it is regarded by many in the US foreign policy establishment as a 'strategic competitor'.

The USA is massively dominant in terms of its military capability, accounting for 36 per cent of the world's total military spending, and a much larger fraction of the production of the world's most advanced weapons. In 1999, the USA spent US$35 billion on R&D in the military sector, compared with just US$9 billion in NATO Europe countries. By 1999, the USA's military budget stood at US$253 billion, compared with just US$135 billion for NATO Europe (IISS, 1999: 37). However, since then, the USA has announced that the military budget will rise to US$379 billion by 2006, while there are no plans to increase real military expenditure by NATO Europe countries (*FT*, 18 February 2002).

The possibility of military collaboration between the US and Europe is being undermined by the growing technological gap between leading European and leading US companies. The 1990–1 Gulf War shocked military thinkers around the world. It provided a vivid demonstration of the way in which warfare had changed since the end of the Cold War, with the application of the principles of what is termed the 'revolution in military affairs' (*International Herald Tribune*, 14 June 1999). It showed clearly that the US stood at the centre of this revolution, in terms both of the production of the relevant technologies and of the assembly of arms to deliver these technologies in battle, and it emphasized the growing gap between the US and Europe.

The war in former Yugoslavia revealed that the gap was growing: 'European leaders lamented their countries' yawning technological gap with the US, revealed by the Kosovo war. Europe contributed only a fifth of the warplanes and very little intelligence to the bombing campaign, while mustering even a peacekeeping force showed up deficiencies in logistics' (*FT*, Editorial, 20 July 1999). The allied governments were supportive of the war effort, but were unable to conduct high-level bombing raids at night due to their inferior technology.

Precision-guided munitions were almost monopolized by US warplanes. Only France and Britain had laser-guided bombs. Even these comparatively advanced European allies remain ill equipped for the revolution in military affairs. Europe fears a situation in which 'the US provides the high-technology aerial surveillance and smart weapons and it provides the footsoldiers' (*FT*, 1 July 1999).

The Afghanistan conflict of 2001 showed that the gap was getting even wider: 'The larger lesson from [the Afghanistan conflict] – and one that is stupefying to the Russian and Chinese military, worrying to the Indians, and disturbing to the proponents of a common European defence policy – is that in military terms there is only player on the field that counts' (Paul Kennedy, *FT*, 2 February 2002). European forces had almost no contribution to make beyond providing the footsoldiers to attempt to control the country after US bombing had destroyed the initial Taliban resistance. Although they were ready to support the US militarily, the NATO allies were simply not needed to fight the war in Afghanistan: 'There has always been a gap in miltary capabilities between the US and most of its other allies. . . . But we are on the verge of a very dramatic disparity precisely because of the way technology is now starting to affect war-fighting doctrine' (*FT*, 18 February 2002).

The attack on Iraq in spring 2003 demonstrated that the gap is growing still wider, and will continue to do so as the US military budget rises while that in Europe shrinks.

The USA has made clear its nervousness about China's growing military capability. Section 1202 of the USA's National Defense Authorization Act for Fiscal Year 2000 provided that each year the Secretary of Defense should provide a report on the 'current and future strategies of the People's Republic of China'. The 2002 Report pronounced that China's defense spending 'may be some four times larger than its public announcement in March 2002 of a defense budget of only about US$20 billion' (*Annual Report*, 2002). It argues that by 2010 'the PLA will have all the elements of a modern air force and should have developed the operational concepts and the training needed to fight as an integrated force' (*Annual Report*, 2002: 18). The Report estimates that China has around twenty intercontinental ballistic missiles capable of targeting the USA, and that this number 'may reach 60 by 2010' (*Annual Report*, 2002: 27). The Report believes that China 'looks upon Russia as its primary source of modern military technologies', with estimates of agreed sales from the former USSR reportedly ranging between US$10 and US$20 billion: 'Since at least 1993, China reportedly has acquired advanced

Russian weapon system technologies for the development of PLA [People's Liberation Army] air, ground, and naval weapon systems, as well as advanced materials and manufacturing technologies associated with missiles, lasers, and space systems' (*Annual Report*, 2002: 43–4).

President Bush's policy statement 'America's Security Strategy' (*FT*, 21 September 2002) warns China:

> [A] quarter century after beginning the process of shedding the worst features of the Communist legacy, China's leaders have not yet made the next series of fundamental choices about the character of their state. In pursuing advanced military capabilities that can threaten its neighbors in the Asia Pacific region, China is following an outdated path that, in the end, will hamper its own pursuit of greatness. It is time to reaffirm the essential role of American military strength. We must build and maintain our defenses beyond challenge. . . . Our forces will be strong enough to dissuade potential adversaries from pursuing a military build-up in hopes of surpassing, or equaling, the power of the US.

As the 2003 war against Iraq demonstrated, today's friends in international relations can be tomorrow's enemies. The current international situation is one of the most unstable for a long time. However unlikely it may appear, China's strategists cannot rule out the possibility that at some point the object of 'regime change' may even include China. It has to shape its foreign policy with this as one possible scenario.[15]

In the year 2000, the US Congress also established the Congressional–Executive Commission on China (CECC) to 'monitor China's compliance with international human rights standards, encourage the development of the rule of law, establish and maintain a list of victims of human rights abuses, and promote bilateral co-operation' (CECC, 2002). The CECC's first Annual Report was produced in September 2002. The Report was extremely critical of many aspects of alleged human rights abuses in China. It also made numerous policy recommendations. It recommended, for example, that Congress and the US Administration 'expand US Government efforts to disseminate human rights, workers' rights, and rule of law-related information in China through radio, television, and the Internet'. It recommended that Congress should 'appropriate funds to an American university, NGO, or other organization to train individuals from US faith-based or other organizations with links to religious groups in China to assist Chinese religious leaders in asserting their existing right of freedom to practice religion under the Chinese Constitution and international human rights'.

The Report points out that 'Chinese leaders are keenly aware of the role that labor unions played in undermining Communist Party rule in Eastern Europe and are determined to prevent similar challenges in China.' It details allegations of Chinese government mechanisms to control the trade union movement, including government actions to break up worker demonstrations, and prevent strikes. It alleges that 'regulations on workplace health and safety, as well as on work hours and overtime pay, are often ignored'. The Commission recommends that the US Administration 'facilitates meetings of US, Chinese and third-country companies doing business in China to identify systemic worker rights abuses, develop recommendations for appropriate Chinese government entities, and discuss these recommendations with Chinese officials'.

The Report argues that the 'massive migration from rural to urban areas and the increased unemployment from shrinking and closing state-owned enterprises have seriously exacerbated worker unrest'. It recommends that the Congress and the Administration 'provide assistance to legal clinics to expand the availability of legal representation in cases involving worker rights, and that special assistance be provided to legal aid centres in communities with large numbers of migrant workers, and migrant women in particular, to build expertise and capacity in resolving the issues of concern to this vulnerable group'. It recommends that Congress 'authorize the development of programming in popular legal education for groups in China, such as farmers in remote areas, and migrant workers, who are unaware of their rights under existing law'.

China faces a fundamentally different position in its international relations than did Japan, South Korea or Taiwan at comparable stages in their development. Japan, Korea and Taiwan each achieved their modern 'take-off' as close allies of the USA in the international struggle against communism, especially the People's Republic of China. Consequently, the USA was willing to tolerate a 'developmental state' in each case, which heavily protected the economy, kept global financial institutions at arm's length, and strongly controlled international financial flows. But after the collapse of the USSR and China's opening-up, the USA exerted strong pressure on each to follow the US model.

As well as intense and mounting military and diplomatic pressure from the USA upon China, there is, as we have seen, an explicit commitment from the US Congress to promote activities within China that would contribute to increased social and political instability in the country at a critical stage in its system evolution. The final shape of the USA's view of how best to 'engage' with China is still unclear. However, there is a powerful set of interests that believes that serious conflict with China is unavoidable. Joseph Cirincione of the Carnegie Endowment warns: 'There are many people in this [Bush junior] administration who think that a war with China is likely, perhaps even inevitable in the next 20 or 30 years. [They think] China will challenge us [and] we'd better be ready for it.' Henry Kissinger, meanwhile, cautions that the hawks see China 'as a morally flawed inevitable adversary' and believe that the US should act 'not as a strategic partner, but as it treated the Soviet Union during the cold war, as a rival and a challenge'. General Brent Scowcroft, former security adviser to two Republican administrations (Gerald Ford and George Bush senior), comments: 'If there is a real division within this [Bush junior] administration, it is probably on China. There is a division between those who see China as inexorably developing into the primary security threat to the US, and those who feel China is transforming rapidly but . . . that it's been overwhelmingly positive' (all quoted in *FT*, 20 August 2001).

Even before 11 September, there had emerged a powerful shift towards unilateralism in US foreign policy under the combined influence of traditional 'realist', but more inward-looking, conservatives and the so-called 'neoconservatives'.[16] In the first year of the Bush administration, the US pulled out of the Kyoto Protocol on climate change and torpedoed the talks to add verification procedures to the Biological Weapons Convention. However, 11 September tipped the balance of influence towards the neocons. The consensus among the inner core of the Bush administration shifted to the view that 'in the long term the US would only find security in a world in which US values were widely held and spread' (*FT*, 6 March 2003).

The 'neocon' version of US 'primacy' is 'revolutionary in the sense of transforming the world in America's image' (*FT*, 6 March 2003). The central assertion of Bush's National Security Strategy 'all but expunges the instinctive internationalism of Roosevelt or Truman': 'America's global power must not be challenged or chained. The US reserves the right to decide who might be its enemies and how they are to be dealt with. No other nation can be permitted to challenge its primacy. Ever.' The powerful shift in US foreign policy towards the neocons' position has been described as one in which 'confidence and insecurity somehow manage to sit side by side': 'At one level, the present administration delights in America's unique power. At another, it lives in terror of the nation's unique vulnerability' (both *FT*, 7 March 2003).

By casting itself adrift from the moderating influence of international institutions, including the cautious voices of 'Old Europe', the US constitutes a dangerous and unpredictable force at the heart of international relations. It remains to be seen whether the shift is a temporary 'blip', marking the final apogee of conservative influence on US foreign policy, or constitutes a seismic shift following 11 September. The increased unpredictability in the foreign policy of the world's hegemonic power constitutes a formidable challenge for China's own foreign policy.

The challenges within the Chinese Communist Party

The Chinese Communist Party, with 64 million members, faces immense ideological and organizational challenges. Leadership by the Party is the foundation of the Chinese modernization drive. In his speech of 1 July 2001 to celebrate the eightieth anniversary of the founding of the CCP, Party General Secretary Jiang Zemin stated that the Party must 'address the two major historic subjects of enhancing the Party's ability of exercising state power and art of leadership and resisting corruption and warding off risks'.

In the late 1980s and early 1990s, Deng Xiaoping had repeatedly warned of the dangers of China collapsing into chaos if the wrong decisions were taken. In the early twenty-first century, in the face of the numerous internal and external challenges outlined above, such dangers are still taken extremely seriously by the leadership. In his speech of July 2001, Jiang Zemin pointed out:

> To rally the 1.2 billion and more people behind the socialist modernization drive in a large and multi-ethnic developing country like China, it is a must to have the strong leadership of the Communist Party of China. Otherwise, the country will . . . not only fail to realize its modernization but also sink into a chaotic abyss. This is a conclusion drawn by reviewing the modern history of China's development and after analysing the experiences and lessons of many countries in their development course.

It is also recognized at the highest levels of the Party leadership that within the Party itself there is a rising tide of corruption. The leadership is acutely aware of the rising social tensions that threaten the continued rule of the Chinese Communist Party. In his above-cited speech, Jiang cautioned: '[W]e must be strict in Party discipline. We should have a deeper understanding of the loss of political power by some Communist Parties in the world that had long been ruling parties and learn a lesson from them.' As the Chinese economy has advanced, and the impact of market forces and integration with the global economy has increased, so the challenges for the Party have intensified, not diminished. Jiang's speech drew attention to the challenges arising for the Party from increasing opening-up and marketization: 'With the progress of reform, opening-up and development of a socialist market economy, the social fabrics, economic composition, forms of organization, means of employment, interests of different sectors, and modalities of income distribution have increasingly diversified. We should be sober-minded about this and pay attention to the trend. Otherwise our country would be deprived of cohesiveness.' Despite immense success in economic reform, Jiang warned that the challenges facing the Party were intensifying: 'The longer the Party is in power, the more necessary it is for the Party to strengthen self-improvement, and the stricter it should be with its members and cadres.'

In his speech Jiang made numerous references to the critical importance of dealing with the rising tide of corruption within the Party as the country moved further down the road of marketization of economic life. He urged Party cadres to 'support and help others first instead of only thinking about how to get rich themselves'. He acknowledged that combating corruption and building clean government was 'vital for the survival of our Party'. In other words, elimination of corruption was vital to the very continuation of Communist Party rule in China. He emphasized that in order to solve the problem of corruption in the Party it was necessary to 'remove the soil and conditions breeding corruption through creative institutional measures', and to 'work harder to prevent and address corruption at its root'. He laid great stress on the importance of solving the problem of corruption among Party leaders at each level, and was blunt about the extent of abuse of power by Party members: 'All the Party members, leading cadres in particular, must always be clean and honest and have a strong integrity. . . . They will by no means be allowed to abuse power for personal gains, take bribes or bend the law. Party organizations and leading cadres at all levels must take a clear stand to oppose corruption.'

In their determined efforts to purge the Party of corruption, the level at which Party members were investigated and brought to trial for corruption rose to include many in high positions. A succession of high-level government officials were forced out of office, and, in several cases, were even sentenced to death, for corruption.

In autumn 2000, a former deputy governor and former mayor of Shijiazhuang, Hebei's largest city, were arrested, charged with 'economic crimes' (*FT*, 22 January 2001).

In December 2000, it was reported that Mu Suixin, the mayor of one of China's largest cities, Shenyang, in Liaoning province in Northeast China, had resigned after being linked with a gambling scandal which had already forced out three other senior city officials, including the deputy mayor (*FT*, 27 December 2000). Mu had become nationally famous for his successful campaign to transform the city's old state-owned enterprises. Chinese state television reported that 'mafia power' had become 'rampant' in Shenyang's politics and economy, which had placed great pressure on Mr Mu. It was later revealed that over 100 officials from the city had been detained. These included some sixty officials from the city's tax bureau, 'from the highest-ranking to the most menial', who were said to be under investigation (*FT*, 2 June 2001). Mr Mu was accused of accepting 'huge bribes' from local 'mafia' groups. These included one run by Liu Yong. Liu was accused of having 'attacked or murdered some 42 people', according to *Xinhua News*. He was formerly the head of the Jia Yang Group, 'a business conglomerate', a representative in the Shenyang People's Congress and a member of the Communist Party. Official sources said that he had bribed 'dozens of city administrators or their wives, including Ma Xiangdong, the former deputy mayor'. Ma was arrested for gambling away US$4.8 million in public funds during seventeen trips to casinos in Macau.

In September 2000, it was reported by the Supreme People's Procurate that a former Vice-Minister of Public Security, Li Jizhou, had been arrested at the end of the previous year.

In December 2000, the former Chief of Military Intelligence, General Ji Shengde, was reported by the international press to have been sentenced to fifteen years in prison for embezzlement and bribery (*New York Times*, 23 December 2000). The main focus of the case against General Ji was his links with Lai Changxin in Xiamen (see below). He was reportedly accused of accepting 'huge bribes' from Lai. General Ji was also reported to have used his position to embezzle millions of dollars from military-run corporations, using the money to invest in the stock market and in real estate. The case of General Ji is of special significance because he is the son of a revolutionary hero and former Foreign Minister of China. General Ji reportedly escaped the death penalty only due to the intervention of his mother.

In March 2000, Chen Kejie, one of nineteen deputy chairmen of the National People's Congress, was sentenced to death for corruption. Chen was the former Deputy Governor of Jiangxi province. He was accused of amassing US$4.7 million in kickbacks from land deals and in return for granting development contracts (*International Herald Tribune*, 1 August 2000).

At the same time, the ongoing campaign revealed important cases of local corruption that raised fundamental issues about the relationship of Party to society at the local level. One of the most notorious concerned the case of Xiamen, the port city in South China's Fujian province. It was to be the largest corruption case in China's recent history up until that point, and atttracted great attention at all levels of society and government.

At the centre of the Xiamen case was a peasant's son, Lai Changxin. His family was too poor to educate him beyond primary school. He began as a clerk with a trading company in Xiamen. Lai 'showed a knack for business and building contacts with police and military officials' (*Asia Week*, 22 December 2000). He set up the Yuanhua Group in the 1980s and in the early 1990s expanded its business to Hong Kong: 'Using his links with the PLA and Hong Kong's position as a regional business hub, Lai built a multi-billion dollar empire in just a few years.' He then began rapidly to develop smuggling operations: 'He started illegally to import everything from cars and gasoline to electronics on behalf of his highly placed friends.' According to official accounts in the Chinese media in late 2000, from 1996 on, Lai and his operatives brought in goods worth RMB53 billion (US$6.4 billion), evading RMB30 billion in taxes. Unofficial reports say that at one point, as much as one-sixth of national crude oil supplies were being smuggled onto the Chinese market by Yuanhua through Xiamen, distorting national oil prices and influencing national energy policy.

In the first round of court cases, eighty-four of Lai Changxin's associates and employees were arrested and convicted. Lai was tipped off and was able to elude arrest. He fled to Canada with his family. Eleven of the eighty-four convicted were sentenced to death. Another three had suspended death sentences, twelve had life sentences and fifty-eight received fixed-term sentences. A second batch of over 200 offenders were eventually tried in connection with the case.

Lai Changxin reportedly bought off 'representatives of almost every arm of the state, including the local Communist Party committee, the customs administration, the police and even the local Bureau of the Ministry of State Security and the People's Armed Police' (*Asia Week*, 22 December 2000). According to the official news reports, Lai bribed the head of the Xiamen customs adminstration, Yang Qianxian, with RMB1.4 million and maintained a mistress for him. Lai had at least three other top Xiamen customs officials on his payroll. He gave the Deputy Director of the Fujian Provincial Police Department, Zhuang Runshun, RMB555,000 in bribes, and Xiamen Vice-Mayor Lan Pu, RMB5.1 million. Others in the pay of Lai included at least one of Xiamen's deputy Communist Party leaders, Liu Feng, the head of the Xiamen Police External Liaison Department, Wang Kexiang, and a top official in the Provincial Police Border Defence Force, Zhang Yongding. Many other top local officials were also later brought to trial, including another deputy Xiamen deputy Communist Pary chief, and a second vice-mayor. The manager of the Fujian branch of the Bank of China (BOC) and the manager of the Xiamen branch of Industrial and Commercial Bank of China (ICBC) were also bought off by Lai. According to the China News Service, the trials included cases against the heads of several of Xiamen's largest state-owned enterprises. The Xiamen Dongfang Group, for example, illegally rented out its export licence and official stamps to Lai's Yuanhua Group for an annual fee of RMB20 million, which was shared by the leaders of the former group.

Lai reportedly 'wined and dined and bribed local police and customs officers into turning a blind eye'. He built a luxurious six-storey entertainment compound, nicknamed the 'Little Red Mansion', 'where official visitors would be treated to karaoke and sex with hostesses'. Sometimes the guests were 'secretly filmed and reportedly blackmailed into co-operating with him' (*Asia Week*, 22 December 2000). According to the Vice-Minister of China's Ministry of Supervision, speaking on CCTV, other types of bribes used by Lai included study abroad for officials' children, apartments, cars and travel permits to visit Hong Kong (procured from Lai's police contacts).

It is striking that the city was able for many years to circumvent the many channels of control that are supposed to prevent such activities. These channels include the Communist Party discipline inspection committees, procurates, courts, the police and the auditing adminstration: 'The completeness with which that system was circumvented in a large, wealthy community that isn't so poor its officials needed to be corrupt, is striking' (*Asia Week*, 22 December 2000).

So deep was the control exercised by Lai Changxin that it proved necessary to send a massive team of investigators from the Central Inspection Commission in Beijing to penetrate the city's ruling apparatus. The team had several hundred members. Naturally, those involved had the strongest possible interests in trying to thwart the inquiry.

The very reason that so many cases of corruption have come to light, and been written about in the Chinese press, is precisely the fact that the Chinese leadership is fully aware of the deep threat that it poses, and is trying hard to do something about it. Official reports to the National People's Congress in early 2003 declared that in the previous five years the war against graft had been substantially stepped up, with a total of almost 13,000 prosecutions of government officials (*South China Morning Post*, 11 March 2003). Chief Justice Xiao Yang reported that a total of 2,622 officials at the county level or higher had been convicted of embezzlement, taking bribes or other forms of graft, representing a 65 per cent increase over the previous five-year period, ending in 1998. It was reported in early 2003 that in Guangdong alone, in the previous five years the government had investigated 1,388 cases of corruption involving 1,470 people, 61 of which had been at the rank of director or higher (*South China Morning Post*, 26 March 2003).

The psychological challenge

Every society depends for its cohesion, for the happiness of its people and for the provision of meaning to life, upon codes of moral conduct conveyed through the family, school, religion or quasi-religious beliefs. Sociologists have devoted much attention to the psychological challenge that faces all fast-modernizing societies as old values are eroded. China confronts unprecedented challenges in this regard. Few countries have undergone such sustained high-speed modernization. However, as we have emphasized, the process of modernization is taking place alongside a sustained role for a massive rural population that will continue to exist for many decades ahead. As we have also emphasized, there is effectively a collision of the eighteenth century with the twenty-first century.

China is integrating with a global economy that has never witnessed such a concentration of business power in the hands of such a small group of giant firms. It is integrating at a time of unprecedented individualism and materialism in global culture. It is integrating at a time of comprehensive influence of one particular culture, that of the USA. It is naïve to imagine that this culture simply repels. It also provides immense attraction to huge numbers of people across the world, especially to young people who are searching for a new frame of reference to provide order and meaning to their lives. This attraction is hugely reinforced by the influence of US-dominated global mass media, which already have deeply penetrated daily life.

China's psychological challenge is greatly increased by the transition from traditional communist values. The values of the Maoist period have been deeply undermined by the rise of the market economy. The struggle to find a new moral content to Chinese communism is a massive, ongoing endeavour that absorbs a great deal of energy of the Chinese leadership. The transition from Maoism has also created powerful generational differences. These are more profound in China today than in most other societies. The older generation was brought up in a radically different moral environment from today's young people. One generation was continually imbued with the values of self-sacrifice, and the model of revolutionary heroes such as Lei Feng. The successor generation is confronted everywhere by the values of a selfish, materialistic market economy.

The whole of Chinese society has been dramatically affected by the unprecedented impact of the one-child policy. No society in human history has implemented such a drastic policy to control population growth. The result has been a uniquely rapid transition in family structure. The proportion of people under the age of fifteen fell from 33.4 per cent in 1982, to just 22.9 per cent in 2000 (Banister, 1987: 34; SSB, *ZTN*, 2002: 96). There has been intense debate among professional analysts and ordinary people about the consequences of this for the psychology of China's young people. In all previous modernizing experiences, siblings have provided a source of mutual support during the stresses of modernization. This psychological 'umbrella' has been removed during China's modernization process since the late 1970s. The widespread view is that the one-child family policy has produced a generation that is unusually aggressive and isolated. Moreover, the drastic decline in family size has heavily influenced the rationale for developing socially cohesive patterns of relationships that may reward dense patterns of family-based inter-dependencies.

China's diverse social groups confront numerous sharply different psychological challenges. At the apex is the small, but immensely powerful, new global middle class, which is fast absorbing the values of the globalized affluent society. Below them are the upward of 40 million people who have been cast out of the secure world of employment in the state sector, and had new, immensely threatening insecurities thrust upon them. Below them are the 150 million or so migrants who have moved from secure poverty in a rural setting to a harsh world of subsistence income with little social protection, feeling the full force of the market economy at its most brutal point. China's farmers also are feeling great insecurity from the impact of environmental deterioration, which is beyond the scope of any individual or group of people to resolve, as well as the threat produced by China's entry to the WTO, and the disruption of rural society caused by the departure for lumpen work in the cities of a large fraction of the most able young people.

Finance

The process of China participating in the international financial system has been compared by many analysts to a boat setting out to sea. There are two key questions to consider. First, what are the prospects for the 'weather'? Second, how well constructed is the 'boat'?

What are the prospects for the weather?

The concept of free movements of capital is fundamentally different from that of free trade in goods. Capital flows are particularly subject to asymmetric information, agency problems, adverse selection and moral hazard. Although such problems may occur also in trade in goods and services, they are intrinsic to financial flows and are far more important in this sphere. Keynes (1936: ch. 12) provides the foundation of the modern critiques of the potentially de-stabilizing effects of uncontrolled financial markets. He strongly attacks the idea that stock markets and currency markets are efficient, and based on rational expectations. He emphasizes the powerful influence of speculation in determining prices in financial markets. He distinguishes 'speculation', meaning 'the activity of forecasting the psychology of the market', from 'enterprise', meaning 'the activity of forecasting the prospective yield of assets over their whole life' (Keynes, 1936: 158). He famously warned of the negative impact of speculation, which he likens to gambling: 'Speculators may do no harm as bubbles on a steady stream of enterprise. But the position is serious when enterprise becomes the bubble on a whirlpool of speculation. When the capital development of a country becomes a by-product of the activities of a casino, the job is likely to be ill-done' (Keynes, 1936: 159).

More recently, Robert Shiller has pointed out the shortcoming in 'many of the major finance textbooks today', which 'promote a view of markets working rationally and efficiently', and 'do not provide arguments as to why feedback loops supporting speculative bubbles cannot occur': 'In fact, they do not even mention bubbles or Ponzi schemes. . . . These books convey a sense of orderly progression in financial markets, of markets that work with mathematical precision' (Shiller, 2001: 67). Shiller has shown that bubbles in financial markets are 'so natural that one must conclude that if there is to be debate about . . . speculative bubbles, the burden of proof is on the sceptics to provide evidence as to why [they] cannot occur' (Shiller, 2001: 67). The initiating factor is often the optimism generated by a feeling that the economy has entered a 'new era', such as the 'internet revolution', the 'Asian Miracle' or the 'new paradigm for the US economy'. Once the speculation process gets under way, powerful positive feedback loops drive markets ever higher. News media 'are fundamental propagators of speculative price movements through their efforts to make news more interesting to their readers' (Shiller, 2001: 95). Once the market starts to climb, 'public speakers, writers, and other prominent people suddenly appear armed with explanations for the apparent optimism seen in the market' (Shiller, 2001: 98). Eventually, the bubble bursts.

The orthodox view is that as markets become more transparent and availability of information increases, the possibility of crises will decline. On the contrary, Keynes believes that speculation is 'a scarcely avoidable outcome of our having successfully organised "liquid" investment markets' (Keynes, 1936: 159). Indeed, he believed that as the organization of investment markets improves, 'the risk of the predominance of speculation increases' (Keynes, 1936: 158). He made much of the fact that Wall Street was 'one of the greatest investment markets in the world', but there 'the influence of speculation was enormous' (Keynes, 1936: 159). Doubtless, the rise of modern technologies to facilitate instantaneous transfers of vast sums of capital would have only reinforced his concerns on this score.

Liberalization of controls on capital movements since the 1980s has precipitated a turbulent period in the history of developing countries. The period has seen a vast amount of capital surge into different parts of the world in search of maximum short-term profit, with powerful 'herd' instincts influencing the behaviour of the investing institutions. Developing countries are especially susceptible to such bubbles, because the size of the financial flows are massive in relation to the size of the economies concerned. The total funds under management of a single asset management company, Fidelity, are around US$1 trillion, several times larger than the value of the entire Chinese stock market, and around the same size as the entire Chinese national product. Directing these giant funds towards developing countries' financial markets is like 'putting an elephant in a bath of water'. These bubbles have been a form of 'Ponzi' scheme, with capital attracted by the prospect of super-normal profits nurtured by a 'growth story', such as the 'East Asian Miracle', inflating asset prices, thus giving further stimulus to capital inflows. Flows of short-term capital for equity investment and private lending have proved far more volatile than long-term FDI. In each case the resulting 'bubble' burst, with disastrous consequences for the real economy and ordinary people, as asset prices collapsed and capital flows were reversed.

The period has seen an unprecedented number and intensity of financial crises: the largest of these were the Mexican 'Tequila crisis' of 1994/5; the Asian Financial Crisis of 1997/8; the Russian crisis of 1998; and the Argentinian crisis of 2001/2. The bubble has burst in hugely different types of economy: these ranged from 'small, well-regulated and open' Hong Kong at one end, to huge, state-interventionist Indonesia at the other. The common factor of the countries caught up in the Asian Financial Crisis was financial liberalization and asset bubbles. The bursting of the bubble has in each case had massive social and economic consequences. In the case of Indonesia, this resulted in 'regime change'. One of the most successful 'developmental states' in the Third World was overthrown in a matter of months from the onset of the Asian Financial Crisis.

Immediately prior to the eruption of the Asian Financial Crisis, at its meeting in Hong Kong in April 1997, the IMF proposed changing the Articles of Agreement to extend the Fund's jurisdiction to include capital movements. It was striking to all international observers that only China and India escaped the worst effects of the crisis, and that they both had strict controls over international capital flows, with only limited convertibility of the national currency. Today, the Chinese economy is growing fast, but the lesson from the past, especially the Asian Financial Crisis, is that perceptions can change overnight. China is today the last remaining large 'growth story' in the world; it already has a huge 'bubble' of FDI, with the largest FDI inflows of any economy in the world.

If controls on financial flows were substantially liberalized, it is highly likely that short-term funds would flood into the country, fuelling asset inflation. China already has extremely high savings rates, and high rates of fixed investment, but with low returns; a large fraction of the massive potential inflow would be highly likely to fuel asset inflation, especially in the property market. It is easy to imagine how the bubble might burst, and the flow of capital be reversed, with huge potential de-stabilizing consequences for the economy and society. There would then be a full-blown 'Chinese Financial Crisis'. A central goal of policy must be to avoid such an outcome.

China has been fortunate in its reform path of 'groping for stones to cross the river'. At the end of the 1980s and in the early 1990s, when there was intense pressure in China for high-speed political reform to precede deepening of economic reform, the former USSR collapsed. This provided an important object lesson for China: it showed that there were huge dangers in pursuing extensive political reform prior to economic system reform; this reality was quickly understood by everyone in China, and people across the world, who could see the dramatic contrast in the outcomes of system change in China and the USSR (Nolan, 1995). The Asian Financial Crisis provided another deep lesson to China's policy-makers: financial system reform is the most sensitive and difficult part of the whole process of system change; if mistakes are made in this area, with its deep roots in the everyday lives of the whole population, they threaten the whole socio-political fabric. The Asian Financial Crisis reinforced the need for China's policy-makers to be incredibly cautious in liberalizing capital flows and moving towards full convertibility.

How strong is the boat?

The Asian Financial Crisis provided China's leaders with a shocking insight into the fragility of the country's financial institutions. China appeared to escape any effects of the crisis, due to the fact that the *renminbi* was not fully convertible. In fact, the crisis had a deep impact through the medium of Hong Kong and Guangdong province.

Guangdong province had two large non-bank financial firms established by the provincial government during the reform period. One was GITIC (Guangdong Trust and Investment Company), based in Guangdong, but with extensive interests in Hong Kong. The other was GDE (Guangdong Enterprises), whose main activities were in Hong Kong, including five floated 'red chip' companies. During the Asian Financial Crisis, GITIC went into bankruptcy and GDE was insolvent, and faced massive restructuring to meet the demands of its creditors. The bankruptcy of GITIC and the restructuring of GDE allowed the outside world to look closely inside Chinese financial institutions for the first time.

Immediately prior to the crisis, they each had been regarded as outstanding institutions by international lenders. In May 1994, Huang Yantian, head of GITIC, had appeared on the cover of *Business Week* magazine, which described GITIC as 'a financial powerhouse that is helping to remake China'. Just before it was restructured, the Hong Kong government awarded GDE the Territory's annual 'Best Management' award. Morgan Stanley selected Guangnan, one of GDE's red chip companies floated in Hong Kong, as one of the world's 'top fifty small and medium-sized companies'.

However, the investigations of both companies in the full glare of international scrutiny showed that they each had huge failures in corporate governance. Both were shown to have followed disastrous lending policies: a large fraction of their loans and investments were made to firms and institutions that were unable or unwilling to repay their debts to GITIC or GDE. A substantial part of their 'investments' were highly speculative, including heavy participation in the property boom in Guangdong and Hong Kong. Even worse, investigations into Guangnan, one of GDE's 'red chip' companies, revealed that it was basically a 'criminal company': a total of thirty-five people from Guangnan were either arrested or had warrants for their arrest issued by the Independent Commission Against Corruption in Hong Kong. Guangnan was a Hong Kong-listed company, a 'red chip', operating in Hong Kong's environment of high-quality rules on corporate governance; over 40 per cent of its shares were owned by public investors; its accounts were audited by a famous international accountancy firm; it had two independent directors, both prominent businessmen from Hong Kong.

The crisis in Guangdong was closely related to a much wider crisis in China's financial system. As well as GDE, there were innumerable other red chip companies operating in Hong Kong; these were able to borrow huge amounts from international financial institutions, frequently acting as guarantors for each other's borrowing. As well as GITIC, there were, literally, hundreds of other 'trust and investment companies' (TICs). The TICs were able to borrow huge amounts from international financial institutions, who believed that the booming local economies from which they originated would ensure high returns. During the crisis it became clear that the total international borrowings by the TICs and red chips totalled as much as US$60–80 billion, amounting to around one-half of China's total foreign exchange reserves. This huge build-up of borrowings had strong 'Ponzi'-style characteristics. International lenders were intoxicated by the 'China growth story', especially that of the 'miracle' economy of

Guangdong province. In true 'Ponzi' fashion, the borrowers systematically borrowed new funds to repay old debts.

As the Asian Financial Crisis exposed the shortcomings of the borrowers ('the rocks appear as the tide goes out'), the international creditors insisted that GITIC and GDE's debts were the equivalent of 'sovereign debt', and that the Chinese government had a duty to repay them. If the Chinese government had accepted this argument, it could have been a disaster for the country's financial system, as the same argument could then have been applied to the entire TIC and red chip system.

Alongside the massive international borrowings by its non-bank financial institutions, a much less noticed form of massive domestic 'Ponzi' scheme was unfolding, most noticeably in Guangdong province. In the 1990s, a mass of newly established, government-backed local financial institutions sprung up. They attracted tens of billions of *renminbi* from across the whole country through the illegal offer of interest rates far in excess of the official rate of interest. This was termed '*gaoxi lanchu*', or 'pulling in deposits through high interest'. The greedy depositors hoped to participate in the 'Guangdong growth miracle'. The collapse of the region's property bubble, followed by the severe impact of the Asian Financial Crisis, led to widespread insolvency in the local financial institutions, and huge anger among small depositors when accounts were frozen, as frequently happened.

The combination of the local *renminbi* 'Ponzi' schemes with the international 'Ponzi' schemes that lured foreign capital to Guangdong presented a huge challenge to the Chinese government. This was a fast-moving 'fire' that threatened the whole Chinese financial system. The critical action that warded off the crisis was the bold and extremely difficult decision taken by the Chinese government to let GITIC become bankrupt. This prevented the 'domino' effect operating from GITIC through GDE and into the entire TIC and red chip system, which was widely insolvent and unable to repay its international debts. This bold action, which incurred deep opposition, can be termed 'cutting the trees to save the forest' (*kanshu jiulin*). It erected a 'fire-break' around the Chinese financial system and gave the government a breathing-space in which to attempt a thoroughgoing 'clean-up' of the country's non-bank financial institutions. Guangdong was in the front line of this critical process, and the government mobilized large numbers of cadres to close around 1000 rural financial institutions and urban credit co-operatives, as well as many trust and investment companies. The episode served as a deep warning of the dangers in China's close involvement with the global financial system.

China's four main banks are in the process of comprehensive restructuring. They have faced deep difficulties over their corporate governance. The cases of GITIC and GDE demonstrate how long and complex will be the process of changing China's financial institutions into well-governed, modern financial institutions. They demonstrate that 'privatization' and stock market flotation, operating according to global rules and regulations on corporate governance, and with close scrutiny from investigative financial journalists, are not sufficient to ensure that China's financial institutions operate in a way that eliminates risk for the country's financial system. They show that for Chinese financial firms to go out into the 'high seas' of global finance before their corporate governance structures have been fully transformed would be incredibly dangerous.

In the big four commercial banks, despite the removal of large tranches of non-performing loans (NPLs) in the late 1990s, the NPLs still stand at an estimated US$500 billion. If the government's exposure to welfare and pension payments is included, then the central government's foreign and domestic liabilities are estimated to be well in excess of China's total GDP. International experts have become more vocal in pointing to the serious risk of financial sector collapse. In late 2002, one senior official at the Bank of International Settlement said: 'This situation can't last for too long if the underlying problem is not dealt with' (quoted in *Far East Economic Review* [*FEER*], 14 November 2002). International commentaries on the Chinese economy have increasingly begun to consider the possibility of a 'sudden loss of confidence that sparks a run on the state-owned banks' (*FEER*, 14 November 2002). Nicholas Lardy, of the Brookings Institution, has argued that the conditions are 'ripe for a financial crisis' (*FEER*, 14 November 2002).

In the late 1990s, especially after the shocking revelations during the Asian Financial Crisis about Guangdong province's financial institutions, and in the light of the central role that finance played in that crisis, the central government began a massive attempt to 'clean up' the country's main financial institutions, as well as local small-scale institutions. These revealed shocking evidence about the state of corporate governance in China's main banks. In the course of the clean-up of the country's financial institutions, huge problems were found from the bottom to the top of the country's financial system.

In early 2002, it was revealed that the five bank officials at the Bank of China (BOC) branch in Kaiping city (Guangdong) had stolen the equivalent of 'nearly US$500 million'.[17] This was the biggest embezzlement case since the founding of the PRC. Xu Chaofan was the branch manager at Kaiping in the early 1990s, until he was promoted to the BOC's offices in Guangzhou. His successors were Yu Zhendong and then Xu Guojun. According to Hong Kong government officials, the three were 'already well-prepared' as their families had already been sent abroad using false passports (*FEER*, 30 May 2002). It is alleged that on 25 October 2001 the three fled to Hong Kong, also using fake documents. From there, they were reported to have fled to the USA and Canada. Some of the money was laundered through Macao as well as in Las Vegas. (*FT*, 16 March 2002). Hong Kong police said that they had arrested two solicitors and a barrister in connection with the laundering of money from the Kaiping branch. The three former managers and their three accomplices were said to have been 'doing this for nine or ten years': 'These guys were massive high rollers. They were gambling and travelling overseas with their families' (investigator, quoted in *FEER*, 30 May 2002).

Relative to the size of Kaiping city, this was a huge theft. Kaiping has a population of only around 680,000 people (SSBG, *GTN*, 2001: 629). In other words, the theft was the equivalent of around US$740 for every citizen of Kaiping. In 2000, Kaiping's GDP totalled US$1,080 million, and its total residents' savings totalled US$1,130 million (SSBG, *GTN*, 2001: 631 and 655). In other words, the theft was the equivalent of around one-half of Kaiping's GDP and one-half of its total savings. Immediately after the managers fled, rumours began to circulate about the alleged theft. On 17 October depositors started to queue at the branch, and the authorities were forced to send in truckloads of cash to meet demands for withdrawals. The *Far East Economic Review* commented: 'Calm was restored within days, but the incident shows how wary the government is of any loss of public confidence in the banks. Some analysts warn that a run on China's debt-laden banks might spark a nationwide financial crisis' (*FEER*, 30 May 2002).

The publicly available information made it impossible to identify exactly how the three managers had exploited loopholes in the BOC's internal accounting systems and escape detection for so long. BOC (HK)'s listing prospectus simply said that the theft had taken various forms, including 'foreign exchange trading activity in violation of regulations, off-balance sheet loans, and the diversion of bank funds to third parties'. Chinese and Hong Kong investigators said that the three men had 'established a pipeline into the Bank of China's foreign currency reserves in Beijing' (*FEER*, 30 May 2002). One method that investigators say was used by Xu Chaofan to shift money offshore was through issuing bogus loans to local township and village enterprises, which then transferred the funds as payment for orders of raw materials to companies controlled by Xu in Hong Kong (*FEER*, 30 May 2002). Veteran police investigators in Hong Kong said that it was 'highly unlikely that the three managers had acted alone'. Other managers were replaced in a 'sweeping clear-out of local branches' (*FEER*, 30 May 2002). By May 2002, the Hong Kong police had arrested four people in connection with money laundering associated with the case, and further arrests were expected. The Royal Canadian mounted police were reported to be investigating a number of people in Canada in connection with the case (*FEER*, 30 May 2002). Part of the embezzled funds were used to build a luxury hotel in Kaiping and a twenty-two-storey office block that housed the BOC office. The hotel manager was a former BOC employee. After the scandal erupted, he committed suicide by jumping from one of the hotel windows (*FEER*, 30 May 2002).

Although senior officials at the BOC, such as its President, Liu Minkang, emphasize that the bank is determined to stamp out graft and improve management, the 'Kaiping affair shows that it has a long way to go' (*FEER*, 30 May 2002). In its report on the Kaiping scandal, *Caijing* (5 May 2002) concluded that it illuminated the 'terrifying complexity and scale of the challenge facing China': 'Only by drawing a lesson from this bitter experience and facing reality bravely will the Chinese banking industry be able to make up for lost time.'

When the National Audit Office (NAO) completed an audit of BOC from the period 1992 through to the year 2000, covering the head office and seven provincial branches, it identified twenty-two possible incidents of fraud or misconduct with respect to transactions totalling RMB2.7 billion (BOCI, 2002: 169). BOC (HK)'s listing prospectus acknowledged that 'incidents involving embezzlement, misappropriation and bribery by BOC officers and employees, as well as parties outside BOC, have also occurred at other BOC branches' (BOCI, 2002: 169).

The deep problems in Chinese financial institutions do not simply apply to the lower levels. At the very apex of the country's banking system, three high-profile senior banking officials encountered serious difficulties, namely Zhu Xiaohua, Li Fuxiang and Wang Xuebing: 'All three were close associates. All spoke excellent English and had cultivated relationships with many of the world's top bankers, to whom they seemed to embody the market-savvy face of a new China. The illusion is now shattered' (*FT*, 16 January 2002). Even more deeply troubling is the fact that Zhu Xiaohua, Li Fuxiang and Wang Xuebing were part of Premier Zhu Rongji's team of 'can-do-commanders'. They attacked issues of critical importance in China's vital financial reforms.

From 1993 to 1996, Zhu Xiaohua held the positions of deputy governor of the BOC and head of the management of China's foreign exchange reserves. In 1996 he was appointed head of China Everbright Bank (CEB). It was one of the group of innovative state-owned banks that was allowed to operate 'free from the mountains of non-performing loans that characterize the traditional big four state banks' (*FT*, 11 October 2002). In 1999, Zhu Xiaohua vanished from public view. It was later revealed that he had been placed under house arrest and required to confess to his mistakes. In December 2000, Zhu's wife, Ren Peizhen, committed suicide by jumping from a building in Chicago. Zhu's daughter, Zhu Yun, suffered a mental collapse. In May 2001, Zhu Xiaohua was formally arrested. On 10 October 2002, the official Chinese news media broadcast that Zhu had been sentenced to fifteen years' imprisonment for crimes committed while Chairman of CEB, including taking a bribe of RMB4 million (*FT*, 11 October 2002). China Everbright Bank had planned to launch an initial public offering (IPO) in 2003, but in early 2002 it was announced that this had been 'postponed indefinitely' (*FT*, 13 August 2002). It was reported that the bank had been subjected to a sweeping government investigation, involving a team of up to 500 officials, who had uncovered 'many improprieties' (*FT*, 13 August 2002).

Li Fuxiang was formerly the head of the Bank of China's foreign exchange dealings in New York, and subsequently became the official in charge of the whole country's foreign exchange reserves, following Zhu Xiaohua. In May 2000 he committed suicide by jumping out of the seventh-floor window of a hospital in Beijing as investigators moved in. The official reason given for Mr Li's death was depression. At the time of his death he was being questioned about his conduct while at the Bank of China and the State Administration of Foreign Exchange, the body which handles Chinese foreign exchange reserves: 'Questions over what happened to the billions of "missing" reserves remain unanswered to this day' (*FT*, 16 January 2002). It was estimated that over the course of the whole year of 1998, the combined total of foreign investment and the trade surplus was US$89 billion. However, the foreign exchange reserves grew by only US$5.1 billion. In 1999, the foreign exchange reserves grew by US$9.72 billion, compared with a trade and investment surplus of US$76 billion (*FT*, 16 January 2002). Most observers believe that a substantial part of the discrepancy can be attributed to capital flight, propelled by widespread concern over the possibility that China might devalue the *renminbi*. However, estimates of capital flight account for only around US$35–40 billion a year, according to some analysts, leaving unexplained the remainder of the discrepancy (*FT*, 16 January 2002).

In early 2002 it was revealed that Wang Xuebing, who had formerly been the head of both the Construction Bank and the Bank of China, two of the 'big four' Chinese commercial banks, was 'being investigated for "credit problems" while at the Bank of China branches, while he was president from 1993 to February 2000' (*FT*, 16 January 2002). In July 2002 it was reported that Wang Xuebing 'and other senior managers' might face prosecution for their role in the alleged fraudulent transactions involving the BOC's New York branch.

There has been much speculation about the circumstances that might spark a full-blown 'Chinese Financial Crisis'. One potential catalyst would be a further significant downturn in the growth rate. The Chinese government is already 'straining its finances to the limit' in order to stimulate growth. Much hinges on the economy's ability to find markets for its surging exports. Another danger is that which would arise 'if the government mistimed its plan to make the *renminbi* fully convertible at a later stage, so that it crashes when savers panic and seek refuge in the dollar' (*FEER*, 16 November 2002). Another potential catalyst would be if the international banks were able to make more rapid progress than is currently predicted in competing within the Chinese market, provoking a run on state banks to transfer deposits to the international banks.

In late 2002, Moodys rated the prospects for Chinese banks as 'stable', but it headlined its report, 'China's banks walk on a tightrope'. The *FEER* commented: 'While it is clearly possible to be stable on a tightrope, the image hardly inspires much confidence' (16 November 2002). It is now widely recognized that a financial meltdown would 'almost certainly be a catalyst for political and social upheaval' (*FEER*, 16 November 2002).

It was only through the bold action of 'cutting the trees to save the forest' (i.e. to make GITIC go through bankruptcy proceedings in order to save the rest of the financial system) that China was able to remain insulated from the worst effects of the Asian Financial Crisis. This action provided a breathing space for the central government to attempt to undertake deep structural reform in the financial system after 1998. However, the depth of the crisis in GITIC and GDE revealed just how deep was the task that faced the Chinese policy-makers.

Under the terms of the WTO Agreement, China's financial firms will face steadily escalating competition from global financial institutions. Structural reform of the country's financial institutions is, therefore, being carried out in extremely challenging circumstances. The period since the 1980s has seen a revolution in global business systems. This includes financial institutions just as much as manufacturing and other service sector firms. Leading financial services firms, all from the high-income economies, have been through a period of unprecedented merger and acquisition, to take advantage of global markets, benefiting from economies of scale and scope in respect to research and development, branding, human resource acquisition, and central procurement (e.g. IT systems). The period has seen the emergence of super-giant financial services firms, such as Citigroup, J.P. Morgan Chase, Deutsche Bank and Mizuho Group. Citigroup alone has annual revenues of US$112 billion and profits of around US$14 billion, many times greater than the entire group of China's 'four big banks'. The explicit objective of the global giants is to penetrate the financial markets of developing countries. They have at high speed acquired dominant positions in the financial markets of most of Latin America and Eastern Europe. When Citigroup acquired Banamex, Mexico's 'national champion' in financial services, the *Financial Times* commented: 'The acquisition of Banamex underscored the rapacious appetite of Citigroup for assets in the developing world.' Citigroup itself said: 'China is top of our radar screen.'

The challenge for China's large financial firms is likely to intensify rapidly within the country as the global giants gain increasing access to the China market. The less able are China's indigenous large financial firms to achieve their own self-reform, the stronger will be the argument made by the global giants to allow them to 'take command of the boat', as experienced sailors who can run the country's financial institutions well. Citigroup argues that the big four banks in China should be 'torn apart into small units in order to avoid a financial crisis'. Undoubtedly this would make it far easier for the global giants to 'rout the enemy one by one' (*gege jipo*).

Conclusion

There is a high probability of 'bad weather'. Policies should not be shaped on the assumption that the 'fine weather' currently being experienced will persist. At sea, storms can develop with frightening speed and devastating results, especially for fragile craft. The 'boat' of the Chinese financial system still faces enormous challenges in getting itself into condition to set out safely upon the high seas of 'close' integration with global financial markets. The fact that so many deep problems in Chinese financial institutions have come to light is precisely because the government has tried to do something to clean up the sector from the highest to the lowest level.

Conclusion

As China enters the twenty-first century, it faces a wide-ranging series of deep challenges that threaten the entire social, economic and political system. The country is in a period of high-speed economic and social change. It has long been pointed out by political analysts that the potential for political instability is especially acute during such periods. The Chinese government is working extremely hard to try to increase its risk management capabilities to meet this challenge.

For each of the enormous challenges that the Chinese government confronts, painful, hard work is required by the country's leaders and by the local Party apparatus. Reforming the Party itself is a massive task. Huge efforts have been expended on raising the capability of the Chinese bureaucracy. The massive effort to try to clean up the country's financial institutions after the Asian Financial Crisis demonstrated vividly the continued and improved effectiveness of this mighty apparatus. In Guangdong province alone, a vast clean-up operation involved thousands of Party cadres at every level. They closed hundreds of local financial institutions, and ensured that their massive obligations were dealt with in a way that preserved social stability. Such tasks are vital for the Chinese development effort in the period ahead. In respect to each of the challenges it faces, important successes have been achieved, but in each there are still huge problems ahead. Because the task is difficult, however, does not mean that it should be abandoned. 'Regime improvement' rather than 'regime change' is the only logical way to proceed in order to meet the needs of China's vast population.

Huge challenges face the leadership in dealing with the deep problems in the agricultural sector, in fast-rising inequality, in the fast-deteriorating environment, and in the challenge of the global business revolution. In each of these areas, intense work by government policy-makers has gone on for many years. Finding a way to minimize the difficulties within severe constraints will require great skill by China's policy-makers.

However, owing to the number and intensity of the challenges that China faces, there is a high possibility that at some point a 'fire' will break out. It cannot be predicted where, when or how. It is highly likely that it will be connected with the financial system. China faces a massive challenge in the financial sector. Deep problems remain within the non-bank financial institutions. China's leading financial firms still have huge unresolved problems of non-performing loans. They will face intense competition within the WTO from global giant financial service firms. Even more dangerous is the prospect of full integration with global financial markets. All economies, but especially developing countries, face huge challenges to their financial and economic system from unregulated flows of international capital.

During the Asian Financial Crisis, China came close to a major financial and, by implications, a social and political crisis. Only by bold and effective policy measures was the country able to survive. With full convertibility of the national currency it would be far harder to survive a collapse of confidence by global financial markets of the kind that has regularly occurred in other developing countries under financial liberalization. If the 'fire' does not begin with the financial system, then it is likely that it will quickly spread into the financial system. If China were to face a financial crisis of the dimensions of those that have regularly attacked developing countries during the epoch of globalization and liberalization since the 1980s, it would be immensely difficult to maintain system stability. The relationship of political instability with financial crisis is long-standing. As Karl Marx pointed out in 1853: 'Since the commencement of the eighteenth century there has been no serious revolution in Europe which has not been preceded by a commercial and financial crisis' (Marx, 1853a: 9).