



# China 2020: Challenges ahead

## China Special

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readers of our series  
**Frankfurt Voice**



- Since the initial transformation from a centrally planned to a market-based economy in 1978, the economy of China has performed remarkably well, growing at an average rate of 9.5% per annum.
- Notwithstanding the tremendous progress on reforms over the past 20 years, further, and more difficult, structural adjustments are needed to move the economy to a more sustainable growth path. Recent accession to the World Trade Organization (WTO) has provided new momentum for reforms to enable China to advance further.
- China faces four major economic and political challenges that have to be addressed to prevent them from becoming serious risks for the country and stifling its growth potential. These challenges include a fragile banking sector, rising unemployment, large government debt, and corruption within the one-party political system.
- With exports becoming a major contributor to GDP, China is expected to maintain a growth rate that over the next ten years will probably be high enough to allow the authorities to advance structural adjustment. Through efficiency gains from these reforms, China should then be able to achieve high growth for another decade, moving its GDP above that of most industrial countries.

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## Introduction

Dear readers,

*This study is the first in a series called China Special which underscores the importance of China as a mega topic at Deutsche Bank Research. The series will discuss China's growing economic and political status and its implications for Asia as a region and the geostrategic implications for the world generally.*

*The first issue assesses China's economic performance over the past two decades and identifies the challenges the country is facing at present.*

*This overview establishes very well that the robustness and momentum of development to date give reasonable underpinning for China's becoming the world's second largest economic power over the next two decades. The prospect is conditioned on progress being made in some crucial elements of China's constitutional set-up, especially in the financial sector. And it implies that the international integration of China will proceed with its entry in the WTO.*

*As things stand today, the next issues of the China Special series will cover the following topics:*

- *China's domestic political challenge – whether economic liberalisation can continue to be successful without political reforms*
- *China's emergence as a potential superpower, with emphasis on regional repercussions*
- *China's reform initiatives for final transformation into a market economy and integration into the world economy*
- *Monetary-policy and financial-market reforms and their implications for the economy as a whole*
- *State-owned enterprise reform and the introduction of corporate governance rules to promote efficient and competitive market-based firms that can serve as engine of sustained economic growth*

*We hope that the analysis provided by this new series finds your interest and helps you in your work. Any feedback from our readers is highly appreciated.*



Norbert Walter



Axel Siedenberg

## China's remarkable performance over the past two decades

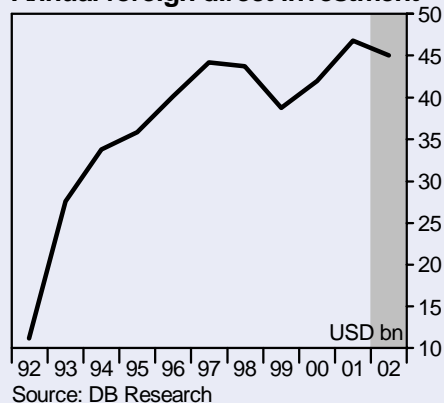
Since the National Party Congress<sup>1</sup> adopted in 1978 an economic policy of opening up to the outside world and reforms aimed at transforming the country's economy from centrally planned to market-based, China's economy has undergone a remarkable transformation. As some of the key components of the 1978 economic reform programme, China has allowed farmers to lease land from collectives and produce agricultural output for their own benefit. These reforms have significantly raised agricultural productivity and gave the first major push that led to the take-off in China's growth during the early 1980s.<sup>2</sup> In addition, China has increasingly opened its doors for foreign trade, removed barriers to foreign direct investment (FDI), and facilitated trade development in order to gain access to capital and new technologies. With its improved infrastructure and large supply of competitive labour, China had attracted USD 392 bn in investment inflows by the end of 2001, and has become the world's third largest FDI recipient after the United States and the United Kingdom. By last year, import tariffs had already fallen by three-quarters, to an average of only 15%. From 1979 to 2001, the economy grew at an average annual rate of 9.5%<sup>3</sup>, reflecting the sweeping reforms. Over this period, growth lifted about 350 million Chinese out of poverty and real GDP per capita rose from below USD 168 to just under USD 1,000, while China's GDP moved from 11<sup>th</sup> place to 7<sup>th</sup> place in the world. In PPP terms, China's GDP is now ranked second, after only the United States.

Besides exceptionally high growth, China's economic policy management has also been remarkably impressive. Inflation, which shot up in the early 1980s, mid-1980s, and early 1990s, has been brought under control over the past decade. The dual foreign exchange rate system was eliminated in 1994 and has since been replaced officially by a managed floating rate system, which is effectively a fixed exchange rate against the US dollar. Since 1996, the Chinese currency, the renminbi, has been convertible for current account transactions, although it remains non-convertible for capital account transactions.

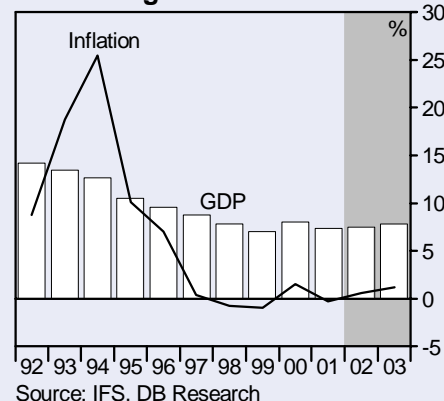
On a micro level, China has also made significant progress with reforms in the banking and enterprise sectors since the mid-1990s. The banking law was enacted in 1996 and steps have been taken to sever banks' credit ties to loss-making state-owned enterprises (SOEs) and to improve internal controls and accountability by holding lending officers and management responsible for loans. In 1995 new joint stock banks (JSBs) were established to create competition for the four state-owned commercial banks (SOCBs) and in 2000 the authorities transferred about USD 169 bn of non-performing loans (NPLs) from the SOCBs to asset management companies (AMCs) to clean up the SOCBs' balance sheets.

The authorities have also established a market-based enterprise system, extending profit-incentive programmes and decision-making authority to almost all SOEs. Since 1984, the government has significantly reduced the mandatory production quotas imposed on

Annual foreign direct investment



Real GDP growth & inflation



<sup>1</sup> The Communist Party of China convenes the National Party Congress once every five years to assess the work of the party in major policy areas during the past five years, define the party's policy and priorities over the next five years and appoint the party leadership. H. Lyman Miller, The Road to the Sixteenth Party Congress, China Leadership Monitor, No.1, September 29, 2001.

<sup>2</sup> OECD, China in the World Economy: the Domestic Policy Challenges, Synthesis Report, 2002.

<sup>3</sup> Available official statistics.

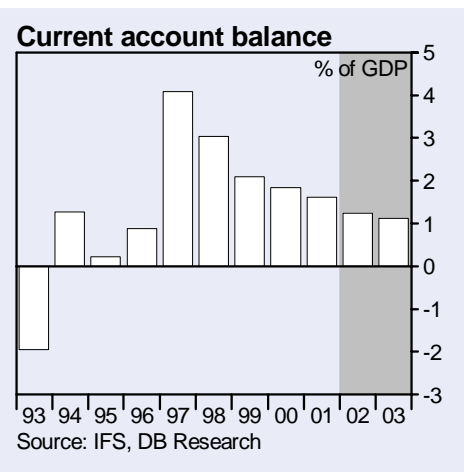
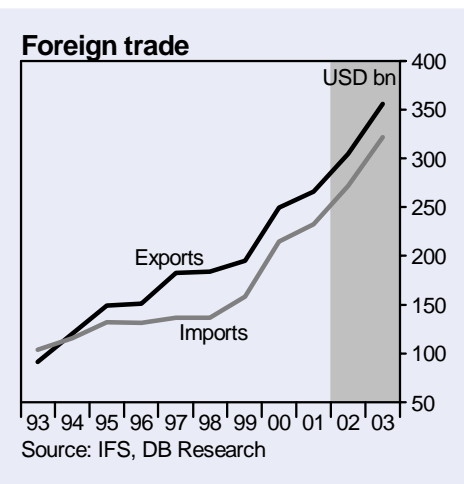
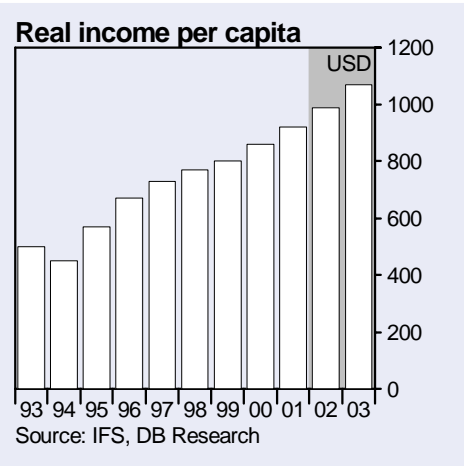
SOEs and administrative price controls. Over the past four years, most SOEs have been subjected to increasing financial discipline. SOEs no longer have easy access to bank loans, and many poor-performing small and medium SOEs have been liquidated or privatised. The larger and more important SOEs that are still considered to be too big to fail have been under pressure to clean up their balance sheets and improve their performance. Many larger SOEs are being partially divested – corporatised and listed – as a means of bringing security-market discipline and improved corporate governance. At the same time, China has also gradually opened up a number of industries, including petroleum, petrochemicals, telecommunications and steel, to foreign investment.

Notwithstanding the tremendous progress on reforms over the past 20 years, further, and more difficult, structural adjustments are needed to move the economy to a more sustainable growth path. Up to now, economic growth has been maintained by massive input growth rather than increased productivity. Persistent macroeconomic imbalances and inefficiencies suggest that this pattern of growth is not sustainable over the long run and a slower growth trend has become more apparent over the past five years.<sup>4</sup> These imbalances stem largely from the SOE sector, which – despite accounting for a declining share of national output – continues to dominate the economy in terms of capital allocation and fixed assets. With at least two-thirds of SOEs making losses, the sector crowds out more efficient uses of funds, and continued support of SOEs through directed lending may raise serious systemic risks and increases the fragility of the banking system. Other factor markets are also segregated across the sectors and regions, based on an increasingly dualistic structure of the economy: the eastern coastal regions are thriving and are in many ways similar to other outward-oriented open economies in Asia. They have increasingly benefited from trade-related FDI and technology transfers. The central and western regions, on the other hand, remain rural, segregated, and poor.

China's accession to the World Trade Organization (WTO) in December 2001, after 15 years of negotiation, has provided new momentum for economic reforms. It has been widely acknowledged that China joined the WTO on stricter terms than current members, committing to open up most sectors, previously protected, to foreign competition. As such, WTO membership will not only allow greater technology transfer and inflows of FDI but will also import policy discipline into the country. China's WTO entry was an important political move as it meant that local officials who objected to structural reforms could no longer do so once the central government signed up to an international arrangement. As importantly, WTO accession is a strategic move by the current leadership in that, under an agreed schedule, it locks in future economic reforms, thus avoiding a loss of momentum or reform slippage during the upcoming transition of leadership (see political reforms section below).

### Major challenges lie ahead

For China to fully exploit its competitive advantages and fully benefit from its integration into the global economy the country would, in our view, have to address four major economic and political challenges to



<sup>4</sup> Cyril Lin, Private Vices in Public Places: Challenges in Corporate Governance Development in China, March 2001.

prevent them from becoming serious risks and stifling China's growth potential. These challenges include a fragile banking sector, high and growing unemployment, large government debt, and corruption within the one-party political system.

## 1. Banking sector very fragile

Over the past twenty years, China's banking system has undergone a significant transformation from a mono-banking system to a two-tiered system comprising a central bank and an increasingly large number of domestic and foreign commercial banks. The domestic banks include four state-owned commercial banks (which account for about 80% of total deposits and over 70% of total loans), 12 joint stock banks and city commercial banks. In addition, there are so called policy banks, which were established to provide priority sectors with soft credits, and a large number of urban and rural credit cooperatives that provide services similar to those of commercial banks.

Problems in the banking sector have stemmed largely from past, directed lending policies to support SOEs as well as continuing support for loss-making SOEs with poor operating capabilities and weak governance. As indicated earlier, with two-thirds of SOEs remaining unprofitable, the SOE sector has crowded out a more efficient use of funds and has threatened the stability of the banking system. Despite reforms in the sector, the People's Bank of China (PBC, the central bank) recently estimated that in 2001 non-performing loans at the four SOCBs made up about 26% of the total outstanding loans (based on China's old loan classification). The high NPL ratio at SOCBs is critically concentrated in the big four SOCBs, which account for about 80% of total deposits and 72% of total loans. PBC's estimate excludes the USD 169 bn in NPLs that had been transferred to asset-management companies in 1999 and 2000. Based on international loan classification standards, however, the central bank indicated that NPL ratios at SOCBs are likely to be higher, probably about 30%. SOCBs' profits, which have been declining over the past ten years, are also low, ranging from negative to 0.33% in 1999. Furthermore, SOCBs are reported to have had average capital ratios, to cushion against bad loans, of only 7% in early 2001, which is below the Bank for International Settlements (BIS) minimum of 8%. JSBs also have high NPL ratios and credit cooperatives, too, are in financial distress.

So far, bad debt has not posed an immediate threat to China's financial sector, in part because the economy has been growing very rapidly and in part because large pools of liquidity from growing deposits have supported bad debt in the banking system. In light of scandals concerning a number of risky, illegal savings schemes, Chinese households, who have a high savings rate, prefer to entrust their savings to SOCBs. However, once China allows foreign banks to conduct renminbi business with Chinese clients and adopts a more flexible exchange rate regime and capital account convertibility, deposits with SOCBs could dry up, as Chinese households would then have better alternative means to invest their savings. Unless domestic banks are successfully restructured before the restrictions on foreign banks' business in China are removed, they could face a potential liquidity crisis.

To prepare SOCBs for foreign competition, the government intends to corporatise and eventually list SOCBs in the equity markets. It is expected that this would impose market discipline on them and improve their functioning as commercial entities. SOCBs have also been instructed to cut their NPL ratios by about 3% annually over the next few years. Moreover, the government has indicated that it will cease

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to move bad loans from SOCBs to the AMCs. Instead, it will assist SOCBs to be listed once they have been restructured into joint stock companies, in order to raise capital, and allow banks to write off their bad loans. SOCBs will also be required to strengthen loan recovery and credit assessment. To improve the profitability and governance of SOCBs, the turnover tax will be reduced to 5% by 2003, and supervisory boards similar to those of non-bank SOEs will be established. In the case of JSBs and credit cooperatives, it is unclear how the authorities will address their current weaknesses. On the demand side, the government is seeking to accelerate the reform of the SOCBs' largest clients, by improving corporate governance in large and medium-sized SOEs and divesting small, loss-making SOEs.

Looking at the authorities' strategies to improve the balance sheets of SOCBs, more would have to be done to ensure the soundness of the financial system. Firstly, given their low profitability, SOCBs are not likely to be able to outgrow their bad loans even if the economy continues to grow at the current high rate. Secondly, according to the central bank, NPLs and the government's contingent liabilities in the form of state guarantees to banks are estimated to amount to about 60% of China's GDP. The longer it takes for the authorities to restore the soundness of the banking system, the higher the cost will be and the more it will impede investment and growth. Thirdly, growing deflationary pressure has threatened to raise the real value of NPLs. Fourthly, the insolvency of SOCBs is linked with SOE restructuring. Massive unemployment resulting from the closing down of public-sector companies could make it difficult for the authorities to immediately cease propping up loss-making SOEs with lending from SOCBs. All these factors point to growing bad debt in the banking sector in the medium term.

## 2. Growing unemployment and disparity between urban and rural incomes

Despite high economic growth, China has been plagued by rising unemployment and growing income disparity between the more developed coastal regions and rural areas. Unemployment has stemmed largely from China's productivity gains in the agricultural sector, the growing labour force, massive labour retrenchment due to industry restructuring and the restriction of labour movement. In 1958 China adopted a system referred to as the *hukou* system, which binds rural residents to their birthplace and restricts them from working elsewhere<sup>5</sup>. The system became hereditary, barring the children of those born in rural areas from employment outside their parents' birthplace. In 1980, the entire rural labour force was employed in the agricultural sector. With productivity rising as the initial result of agricultural reforms, farmers switched from agriculture to higher-paying industry. Township and village enterprises (TVEs) were fostered as a means of absorbing surplus labour from the agricultural sector<sup>6</sup>. As such, during the early part of the 1980s, about 13.6 million net jobs were created annually. However, even during this rapid growth period, TVEs did not expand sufficiently to absorb the surplus rural workers, resulting in underemployment. In the 1990s, the net job increase declined to a total of about 8.1 million annually. TVEs, which faced increased credit tightening as the result of the rise in NPLs, were no longer able to create new employment.

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**About 200 m workers are already unemployed or underemployed in rural areas**

<sup>5</sup> Dan Ewing, China Needs Labor Mobility, Far Eastern Economic Review, March 14, 2002.

<sup>6</sup> OECD, loc. cit.

With no new employment in the rural areas and with the *hukou* system still in place, the OECD estimates that about 200 million workers are either unemployed or underemployed in the rural areas. Additionally, rural income has been depressed over the past several years by weak prices stemming from surpluses in agricultural output, despite the government's policy of supporting agricultural prices. In 2000, rural incomes rose 2.1% to an average of USD 272, compared with USD 763 in the cities<sup>7</sup>. This problem is particularly serious as about 80% of the Chinese population lives in rural areas. Furthermore, China's WTO accession is expected to lead to increased imports of agricultural products in which China has a competitive disadvantage. This is expected to cause a further exodus from the rural areas.

Apart from hardship due to unemployment, rural residents have been burdened by ad hoc charges and fees imposed by local government and other agencies. These fees have increased rapidly in recent years and as some of the charges have been collected by officials for personal use, this is causing resentment and protests by farmers and rural workers. With dismal employment opportunities in the rural areas, it is estimated that as many as 120 million workers have migrated illegally to urban areas in search of jobs. But urban unemployment has also been growing. Since SOEs and urban enterprises began to cut excess workers in the second half of the 1990s, net job increases have dropped to an average of 6.7 million annually since 1995, barely meeting the natural increase in the labor force. Since then, unemployment has been rising rapidly and is estimated to be more than 10% in the formal sector and significantly higher in the informal sector.

Over the next five years, it is expected that there will be at least 20 million displaced workers and new entrants to the labour market every year. Unless the economy grows at a rate high enough to create new jobs to absorb the vast pool of job seekers, this could cause social unrest and pose a real threat to stability.

The government has anticipated that continuing reforms may bring unemployment shocks. For the 2001-2005 period, it has set a target economic growth rate of 7% and has pledged to continue to be proactive with pump priming, in order to ensure that the target growth is achieved and that enough new jobs are created to accommodate the growing labour force. Moreover, the government has emphasised that, to ensure China's stability during the transition period, it will cushion the negative impact on affected workers with fiscal support and improve rural income by reducing the tax burden and supporting investment. In particular, the government is planning to promote the economic development of 2,600 counties, which include about 30,000 to 50,000 townships, nationwide to create rural employment and attract foreign investment to the interior and rural regions. In addition, the authorities have earmarked CNY 530 bn (USD 63 bn) to build infrastructure for the western and central regions and CNY 230 bn (USD 28 bn) to expand agricultural irrigation systems and develop public utilities<sup>8</sup>. To alleviate the local tax burden on farmers, the government will extend a pilot rural tax reform scheme implemented in Anhui to other provinces in order to prevent the protests by farmers and jobless

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**Unless the economy grows at a rate high enough to create new jobs, there could be waves of social unrest**

**The government is taking pre-emptive steps to cushion the negative impact of economic reform on rural regions**

<sup>7)</sup> David Murphy, Buried Deep Down on the Farm, Far Eastern Economic Review, May 2, 2002.

<sup>8)</sup> Laurence J. Brahm, Economy and Reform: Stark Challenge, China's Century: The Awakening of the Next Economic Powerhouse, 2001.

rural workers from spreading. Lastly, the government has recently indicated that the *hukou* system will be revised to allow movement between rural areas and small cities within the country. This will not only ease unemployment pressure in the rural areas but also encourage better factor allocation and better integration among regions.

### 3. Growing public debt

At first glance, China's public finances appear in a relatively good shape compared with other emerging markets. The fiscal deficit has been kept between 2% and 3% of GDP over the past four years and is expected to reach about 3% in 2002. Government debt is estimated to total about 32% of China's GDP; two-thirds is domestic debt. A closer look at the government's finances, however, reveals that the debt could be as large as 100% of GDP if contingent liabilities are included. Nevertheless, the public debt is expected to remain sustainable over the medium and long term given the central government's large stock of assets – so long as the authorities take steps in the immediate future to prevent government liabilities from escalating further.

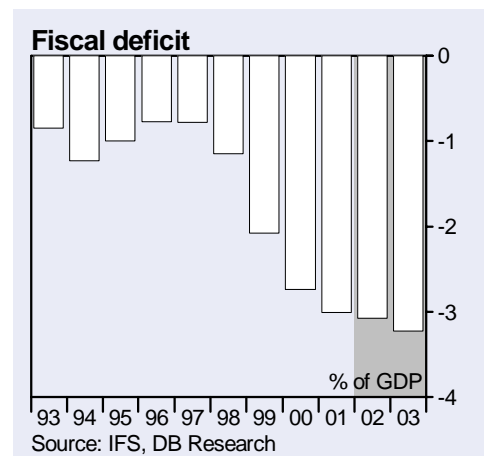
China's tax revenues are relatively low. Even after recent tax reforms, the central government's revenues have only improved from a low 10.2% of GDP in 1996 to about 17% in 2001. Including fees collected by local government and contributions to social insurance funds, revenues are about 21% of GDP, not too low in comparison with other countries (e.g. India) but still insufficient given that expenditures are expected to grow rapidly:

Firstly, with the banking sector already plagued by NPLs, the government has increasingly relied on fiscal policy to achieve high GDP growth. Fiscal stimulus, which was supposed to be a temporary measure during the Asian crisis, has been extended for the fifth straight year and is likely to continue over the next several years for the purpose of maintaining high growth in order to facilitate structural adjustment.

Secondly, it is estimated that bad debt in the banking system amounts to about USD 400 bn. Adding to this the contingent liabilities in the form of government guarantees, public debt stemming from the banking system alone could be as high as USD 800 bn. Thirdly, China's pension system, which was established only in 1995 and is still confined mainly to urban areas, is not financially viable. Despite recent changes to future pension benefits, the government would have to contribute USD 6 bn to the state pension fund by 2004 and about USD 110 bn by 2010 (more than 4% of GDP), according to estimates<sup>9</sup>, to finance the urban pensions alone as more people retire. The government's contribution would in fact have to be significantly larger if the system were expanded to cover the nearly 80% of workers that are not presently covered. Fourthly, demands on the public finances are likely to grow with continuing SOE restructuring, building of market-based institutions, strengthening of the country's human resources and enhancement of the physical infrastructure.

Solutions to growing fiscal pressures would entail the streamlining of the central government's tax revenues, the divestiture of its assets, and a quick move by the authorities to clean up NPLs in the banking system to prevent the costs from escalating. The authorities recently announced that in the upcoming tax reforms, China will unify income taxes for domestic and foreign enterprises, enlarge the coverage of individual income tax, adjust consumption and business taxes, turn ad hoc fees into taxes and reform agricultural taxes and fees. Based on

**Public debt could reach 100% of GDP if the government's contingent liabilities are included**



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<sup>9</sup> David Murphy, Pension Pinch, Far Eastern Economic Review, April 11, 2002.

rough estimates by the OECD<sup>10</sup>, the reforms, together with improved tax collection, could raise the tax revenues by several percentage points of GDP. With GDP expected to grow at a high rate over the next two decades, the actual tax revenues would increase significantly.

More importantly, China has a large stock of assets that could be sold to pay off the NPLs and other liabilities. According to estimates, the 50 largest companies in China under central government control have assets worth USD 1.1 trillion based on their book value. Last year, the government indicated that it would sell some of its shares in already listed joint stock companies, worth about USD 387 bn at the end of 2000<sup>11</sup>, to fund the pension and other social safety net requirements. However, in light of the poor market sentiment last year and the underdevelopment of the equity markets in China, fear that a rapid reduction of large government holdings would unduly destabilise the market prompted the government to suspend the sales of its shares. Nevertheless, with the authorities moving to advance reforms in the equity markets, including a merger of the A and B share markets, it would be easier for China over the medium term to meet its funding requirements through sales of shares in well-performing state-owned enterprises.

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#### 4. Political risks

##### A. Corruption and weak legal framework

Like many transition economies, China is confronted with corruption. According to official figures published in January 2002, the Communist Party of China (CPC) prosecuted 175,000 of its own members for corruption in 2001, which is 30% higher than in 2000. Not only cases involving lower-level CPC members, but also those related to senior officials are on the rise. Corruption is rife in all areas of business. According to a staff estimate of the International Finance Corporation in Beijing, about 80% of first-generation managers in securities business are serving time in jail for fraud.

Given China's stage of economic transition, it is not surprising that corruption is an issue in the country. Over the course of two decades of reforms, as the centrally planned system has not yet been fully replaced by a market-based system, there have been loopholes for corruption activities.<sup>12</sup> Weak enforcement of the improved legal and regulatory framework has also exacerbated the problem. In particular, the courts have yet to become independent and their jurisdiction has yet to be adequately established. According to the constitution, judicial proceedings are free of interference from government and other political entities; however, judges, courts and other judicial organs remain under their supervision and dependent on them for funding.

In the northern industrial rustbelt region of China, where unemployment is higher than in the rest of the country, there have been increasing protests by jobless workers not only against the local authorities' failure to provide a social safety net but also against official corruption. Recognising that corruption could cause strong social resentment which could lead to instability, particularly in light of the increasingly large number of workers affected by SOE restructuring, the authorities have severely punished those caught for serious economic offences. During the last National Party Congress, the CPC urged party officials to abide

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<sup>10</sup> OECD, loc. cit.

<sup>11</sup> Far Eastern Economic Review, loc. cit. (see page 8)

<sup>12</sup> Huan Weiding, Fighting Corruption Amidst Economic Reform, China's Century: The Awakening of the Next Economic Powerhouse, 2001.

by the law and serve the interests of the Chinese people, and vowed to continue its anti-corruption campaign. To tackle both the root causes and prevent corruption, the authorities recently announced that they will separate the function of revenue management from that of expenditure management in all public institutions. In addition, administrative screening and approval procedures as well as the tender invitation system for infrastructure projects will be simplified and made transparent.<sup>13</sup>

The Supreme People's Court has developed a plan for independent funding of the judiciary to make it more independent of local governments. In addition, changes have also been introduced regarding positions for judges. Starting from last year, such positions are no longer reserved for retired military personnel but are also open for candidates who have academic training in law. Despite the reforms discussed above, however, it will take time for China to establish an adequate legal and regulatory framework and strengthen enforcement in order to effectively eliminate corruption.

#### B. Political reform within a one-party political system

The ruling Communist Party has been gradually and quietly introducing political reforms over the past several years to make the party more relevant to modern China. Starting from the 15<sup>th</sup> National Party Congress in 1998, the CPC set a new direction in the way of thinking and the approach to political reform, calling for "rule by law" to replace "rule by man" in China.

Over the past two decades, the CPC leadership has debated on what kind of party the CPC should become and how to shape it under the new economic environment to ensure that it remains an essential part of China's changing society. In response to the debate, President Jiang Zemin proposed last year that the CPC adopt as the foundation of the party the concept of the "Three Represents", namely the party must represent (i) the "advancement of productive forces", (ii) the orientation of "advanced culture", and (iii) the fundamental interests of the majority of the Chinese people. This concept would allow the party to expand its membership and representation beyond workers and peasants to include the whole population of China, particularly the new urban elite. Despite opposition from more conservative party members, all members of the current politburo have endorsed the concept. In 2002, the CPC constitution was rewritten to incorporate the new concept of "three represents" and to allow the party to extend membership to intellectuals and entrepreneurs.

Experiments on the checks and balances on the Party's power are also under way in southern China. In a special economic zone near Hong Kong, the performance of each government department is graded by the local companies it serves. Those that receive poor grades have to forfeit their year-end bonus.<sup>14</sup>

China will have a leadership transition in 2002. Fully half of China's top government officials are expected to retire in the coming months, making way for the fourth generation of leaders. The first generation was led by Mao Zedong, the second by Deng Xiaoping, and the third by current President Jiang Zemin. A new party leadership will be selected

**The ruling Communist Party has quietly introduced political reforms over the past several years**

**In 2002, the Party constitution was rewritten to allow the party to extend membership to intellectuals and entrepreneurs**

**China will have a leadership transition in 2002. Under the new leaders, continued market liberalisation is likely to remain one of the top priorities**

<sup>13</sup> BBC Monitoring Service – United Kingdom, February 21, 2002.

<sup>14</sup> James Kynge and John Thornhill, Comment and Analysis: Who's Hu?: Little known outside China, the country's next leader appears to be a skillful political and economic moderniser – but no mould-breaker, Financial Times, Feb 4, 2002.

at the next party congress scheduled for the autumn and a new government will be appointed at the next People's Congress in March 2003. Hu Jintao, who is currently China's vice-president, is likely to emerge as the new general secretary of the Communist Party. Besides Hu, the fourth generation includes current vice-premier Wen Jiabao, who is likely to become premier, and Zeng Qinghong, a senior communist party official who could become vice-president. Based on the previous political transition, these men are likely to be the leaders of China for the next two five-year terms. More importantly, being well educated and well informed of developments both inside and outside of China, the fourth generation leaders are likely to be more flexible, open, pragmatic and moderate.

Under the new leaders, continued market liberalisation is likely to be a priority. Wen, who worked as an economic assistant to reformists Zhao Ziyang and Hu Yaobang, has been overseeing financial-sector and rural employment. He is also known to have been in charge of policies to narrow the income gap between the urban and rural areas, ease the tax burden on rural residents and remove the *hukou* system.

Beyond extending CPC membership and introducing a system of checks and balances on power within the party, it is highly unlikely that the new leadership will abandon the one-party system in the immediate future. However, with Chinese citizens becoming more affluent and better informed and educated, it might be difficult for the CPC to avoid a multi-party system over the next decade unless the authorities can generate high growth and continuing prosperity to counter growing unemployment, eliminate official corruption and guarantee social and economic justice.

### China's GDP could surpass that of most industrial countries over the next twenty years

Nevertheless, the economic challenges identified above are difficult to overcome and the social and political-instability risks stemming from growing unemployment are real. To keep reform on track, an even stronger GDP growth than 7% per annum would be necessary in order for the government to keep unemployment under control and address the structural issues. Growth over the next ten years is especially essential, as it would provide the government with the resources needed for industry restructuring and support of workers affected by reforms. Even with growth rate of 7-8% during the past few years, unemployment has been rising. If China is unable to achieve growth beyond 7% during this period, absorbing the surplus workers could imply a drop in productivity. Thus sustaining and even accelerating growth (without compromising on stability) is crucial. Without sufficiently strong growth to absorb the displaced and new labour market entrants, there could be increasing social unrest and leading to resistance to structural reforms. In this eventuality, China would have to delay structural reforms to avoid social and political instability, which, in turn, would reduce sustainable longer-term growth and result in a vicious cycle of weakening economic activity and increasing social hardship.

We are of the view that China could maintain a growth rate of at least 7% over the next ten years, for a number of reasons. As indicated earlier, China has been very successful in attracting large inflows of FDI, together with technology and management-knowledge transfers. The combination of rapidly expanding physical infrastructure (primarily

**Beyond extending membership and introducing a system of checks and balances on power within the party, the one-party system is expected to remain unchanged. However, with Chinese citizens becoming better informed, the authorities will have to generate prosperity and drive out corruption in order to maintain the one-party system**

#### China's projected economic performance

	2001	2010	2020
GDP, USD bn	1,159	2,600	7,350
GDP per capita, USD	908	2,000	6,000

Source: IFS, DB Research estimates

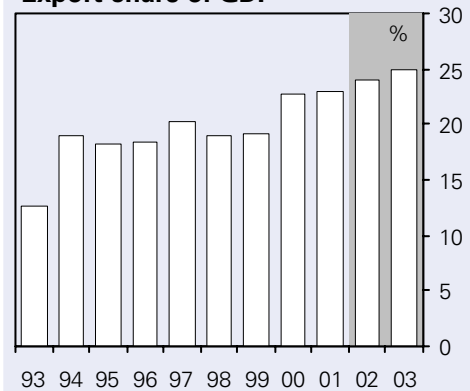
in the coastal areas) together with a large supply of low-cost labour has made the country an exceptionally competitive manufacturing base for multinational corporations and smaller companies from Japan and the rest of Asia, including Korea, Hong Kong, Taiwan, Malaysia, Singapore and Thailand. As most foreign-invested enterprises produce for export markets, exports have increasingly become a major contributing factor to GDP growth – with their share of GDP growing from 13.5% in 1990 to 23% in 2001. Over the next two decades, exports are likely to grow at an even faster rate as a result of trade and investment liberalisation.

Despite China’s investment in infrastructure, education, and research and development over the past several years, investment in these three areas remains relatively small. The government’s plans to build infrastructure in the western and central parts of the country as well as to invest more in education and R&D will certainly provide further impetus to increase total factor productivity and hence growth. The improved infrastructure in the far-flung regions coupled with abundant supply of unskilled and increasingly skilled labour will only enhance the country’s attractiveness in foreign investors’ eyes. China should thus become even more competitive, over the foreseeable future, in providing a low-cost high-skilled manufacturing base than any other emerging market in East Asia. FDI, as such, should continue to rise to and thereby further contributing to growth as China opens its markets further to foreign competition.

Should growth be sustained and major structural reforms be advanced as anticipated over the next ten years, China would be in a strong position to exploit efficiency gains from the reforms and could probably grow at a similar rate (7 to 8% per annum) for another decade. As growth has so far been largely of poor quality due to a large SOE sector and an underdeveloped non-state sector, this means that China still has a large untapped growth potential that could be realised through increased productivity and efficiency gains stemming from reforms. Thus, it is likely that China’s GDP will rise above that of most industrial countries over the next two decades.

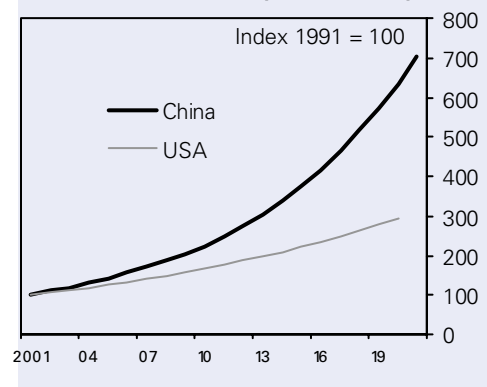
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**Export share of GDP**



Source: IFS, DB Research

**Projected GDP growth over the next two decades (USD terms)**



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