

China

Status Index (Democracy: 3.05 / Market economy: 5.79)	4.42	Management Index	4.49
HDI	0,755	Population	1,300.0 Mio.
GDP p. c. (\$, PPP)	5,003	Population growth¹	1,2%
Unemployment rate	4,3% (2003)	Women in Parliament	20,2%
UN-Education Index	0,84	Poverty²	16,6%
		Gini Index	44.7
Sources: NBS; UNDP: Human Development Report 2005. Figures for 2003 – if not indicated otherwise. ¹ Annual growth between 1975 and 2003. ² Population living below \$ 1 (1990-2003).			

A. Executive summary

In business circles, the overall economic and political development of China is assessed very optimistically. However, according to BTI criteria China's performance is much more ambivalent.

During the period of review, the transformation process progressed in certain respects. GDP growth further increased and the HDI value also improved. Due to the pressure exerted by World Trade Organization (WTO) membership, the rule of law advanced in the area of economic law and with regard to the economically most developed regions.

WTO membership and the strengthening of economic ties with the Association of Southeast Asian Nations (ASEAN) also deepened China's international economic integration. The continued fight against terrorism provided China with the opportunity to display itself as a cooperative, reliable member of the international community. This also improved bilateral relations with the United States. However, the unresolved question concerning Taiwan's status still contributes to potentially significant regional tensions and larger scale conflict.

The most pressing key unresolved issues in China's development include reforms in the following areas: the financial sector, restructuring state owned enterprises (SOEs), environmental degradation and the development of adequate social security provisions. Increasing regional developmental disparities and resulting popular discontent, mainly in the least developed areas, further aggravate China's problems. If these challenges are not addressed quickly and properly, they might well constitute a severe burden to further economic development as well as to the legitimacy and the steering capability of the Chinese leadership.

In the political sector, the latest amendment to the Chinese constitution related to the smooth transition to the "fourth leadership generation" further legitimized the existence of private property by incorporating Jiang Zemin's "Three Represents"

as the state and ruling party's guiding principle. This also resulted in more safety for the private sector, which proves increasingly more important to Chinese economic development. The constitutional amendment also altered the self-conception of the Chinese Communist Party (CCP) from a class-based to a catchall party, thereby eliminating references to the Maoist concept of class struggle and broadening CCP's support base. Furthermore, the amendments also signal that economic nationalism takes precedence over egalitarianism.

However, this ideological shift has not been accompanied by further political liberalization. The fourth generation political leadership also rules out transformation towards liberal democracy. Thus on the whole, the transformation process in China remains essentially limited to the economic realm. Here, improvements have to be emphasized, but these are matched by severe transformation deficiencies. Therefore, the transformation process remains unstable and imperiled by economic and/or political shake-ups.

B. History and characteristics of transformation

The economic transformation process in China started with the adoption of the Opening and Reform policy in 1978. After the upheaval of the Cultural Revolution, this new era is characterized by the Chinese leadership's aspiration to economic and political consolidation. Although China faced some structural deficiencies at the beginning of the 1980s, economic development was facilitated by specific circumstances not often found in developing countries. First, the large rural workforce eased the recruitment of cheap labor for the emerging industrial sector. Furthermore, despite the existence of a planned economy in China, the public sector remained rather limited.

The economic reforms were further supported by a consensus amongst the Chinese leadership to determinedly follow the Opening and Reform policy. However, the leadership also agreed to strictly limit reforms to the economic and political areas, and liberalization was rejected.

Another characteristic of the Chinese economic reform process is the gradual and experimental implementation of reforms. Without a detailed road map for reforms, China's leadership allowed reform initiatives from lower administrative levels to be implemented locally and on a trial basis. If successful, these initiatives were adopted as national policies. One prominent example is the introduction of the so-called household responsibility system in agricultural reform. Its implementation in the countryside resulted in rapid raise in rural income and then rural industrialization. Consequently, this experimental policy served as a model for national agricultural reform policies.

Economic reforms proceeded in a highly decentralized way and allowed for a gradual change which evaded transformation shocks as have occurred, for

example, in the Russian Federation. The decision to allow for the coexistence of a planned economy and a gradually emerging private sector was most important for the maintenance of economic stability. In the course of the reform process, the de facto economic importance, as well as the political appreciation, of the private sector increased steadily. Finally, the latest revision to the Chinese constitution in March 2004 guarantees protection of private property and acknowledges the importance of the private sector to the national economy.

Economic reforms were accompanied by yearly GDP growth rates of approximately 9.7% (1980-2004) and relatively low levels of inflation. This resulted in significantly improved standards of living for the Chinese population. In fact, China succeeded in lifting more than 400 million people out of poverty in the last 25 years. Today only about 5% of the population survives on less than \$1 dollar a day and are thus considered “poor”.

However, serious problems remain and in part became apparent during the course of China’s accession to the WTO. Among these, the most serious are rampant corruption, an inefficient legal system, government agencies that are unable to properly implement laws and regulations in accordance with WTO requirements, and a lack of sustainability in economic development. A lack of sustainability results in serious deterioration of the environment, which in turn will cause enormous economic and social costs in the long term and thus burden further development. In addition, the widening income gap between urban and rural regions, as well as between coastal and inland provinces, the lack of adequate social security, health care and pension systems all constitute serious problems. Furthermore, China is less and less able to fulfill the demands of the growing middle class for education, befitting employment opportunities and, finally, political pluralism. All these problems result in a continuing erosion of the legitimacy of the ruling CCP and have the potential to cause social unrest.

In the past, the “third leadership generation” headed by Jiang Zemin and Zhu Rongji succeeded in adapting to changing economic circumstances but failed to initiate political transformation towards more democracy and rule of law. The “fourth leadership generation”, for instance President Hu Jintao and Prime Minister Wen Jiabao, which came into office in March 2003, tries to cope with these problems by broadening the legitimacy base of the CCP, transmuting it from a class supported party to a party supported by the whole populace. It remains to be seen whether the Chinese leadership’s endeavor to integrate all social forces into the CCP and thus to strengthen the party’s leadership will prove successful.

C. Assessment

1. Democracy

Politically, China is still plagued by profound transformation problems. Severe and continuous human rights violations, the suppression of ethnic minorities (mainly in two autonomous regions or AR, Tibet and Xinjiang), political opposition and religious or spiritual groups (mainly the Falungong) impair transformation achievements in the economic area as well as the successful abatement of poverty.

1.1. Stateness

There is certainty about the nation's existence as a state and virtually no competition for the state's monopoly on the use of force. Taking into consideration significant exceptions, Taiwan, which is regarded as a "renegade province" by the Chinese mainland, and of continuing secessionist activities in Xinjiang and Tibet, there is agreement about who qualifies as citizens of China. According to the Chinese constitution, all citizens enjoy the same basic civic rights. Ethnic minorities are vested with certain, albeit limited, autonomy rights by the constitution. In principle, the constitution constitutes the separation of church and state, but, even with reform and more openness, only five religions (Protestantism, Catholicism, Buddhism, Daoism and Islam) are officially recognized yet strictly supervised by the Religious Affairs Bureau. Moreover, frequently conflicts occur between the state and different religious or spiritual groups, such as underground Protestant churches and Catholic communities allegiant to the pope or the Falungong sect, in case these groups fail to subordinate to the CCP's claim to the monopoly of power.

In contrast to other developing countries, especially large territorial states, in China a fundamental and sufficiently differentiated bureaucratic structure extends over the entire territory. However, concerning fiscal issues, conflicts persist between different layers of the administration. The central government delegated public expenditure responsibilities (mainly in the areas of health care, unemployment, pension, infrastructure building and maintenance) to lower government levels. However, without an efficient system of revenue transfers, neither vertically from the central to the local governments nor horizontally from well off to poorer provinces, many provinces mainly in the more traditional inland areas are not able to perform the functions assigned to them. Thus, local governments' efforts to raise extra-budgetary revenues through extra-legal charges and fees for government service or through the establishment of quasi-public corporations to manage "development funds" are primary sources of discontent and protest among the populace as well as the basis of conflicts between central and local levels.

1.2. Political participation

According to the Chinese constitution, China is “a socialist state under the people's democratic dictatorship”. The formal arrangement of political institutions is characterized by the supremacy of the CCP; thus, China's political system can be classified as a centralized socialist dictatorship of the ruling party. Elections are held regularly at central and local levels. Especially at the central level, elections fail to qualify as free and fair. At the local level, limited venues for participation have been established in recent years. Since 1998, local elections are implemented nationwide and in October 2004, the National People's Congress (NPC) Standing Committee adopted important amendments to legislation covering these elections and the makeup of local governments. These amendments increase public participation. They also stipulate the removal of local congress members who win elections through vote buying and thus intend to increase the fairness and transparency of local elections.

All leading political personnel are recruited from the ranks of the CCP; this means the CCP, which is organized as a cadre party, is the most important and most exclusive conduit to political leadership. Other political organizations in competition with the CCP are prohibited and suppressed. The so-called “Democratic Parties” should not be considered opposition parties; rather they are associations of intellectuals, professionals, scientists and capitalists. These groups nevertheless influence the CCP and NPC to a certain degree due to their expert advice. Moreover, at the local level, individuals, mostly entrepreneurs, also campaign for local office as independent candidates and at times win local elections (even against the wishes of the local CCP). Freedom of assembly is guaranteed by the constitution but in practice, the state often interferes with this right.

Due to the CCP's exclusive claim to power there are no independent political groups. This seriously compromises the development of a civil society. Furthermore, freedom of speech is severely limited since most influential media are controlled and/or owned by state bodies. More leeway is allowed for the critical coverage of economic affairs. Even this is limited to the exposure of corporate wrongdoing and economic corruption. However, in 2004 official crackdowns on more liberal media occurred more frequently. This means that even in the limited area of economic coverage there is no indication for a continuous trend of media liberalization. The same is true for new media, such as the Internet, where government control on contents and access is still very tight.

1.3. Rule of law

The political system is characterized by the Leninist principle of concentration of state powers. Since the CCP is regarded as superior to the people and even to the constitution, the separation of powers, a system of checks and balances, and

subordination of the party and state powers under the law, are non-existent. Even if the March 2004 amendment to the constitution explicitly codified the protection of human rights, CCP cadres and state organs de facto have the boundless power to interfere with basic human rights as well as with civil, political, cultural, social and economic rights.

Although the Chinese legal system contains legislation that enables citizens to sue the government, such as the Administrative Litigation Law, nevertheless the judiciary cannot be considered a reliable safeguard against violations of human and civil rights or official misbehavior. First, judicial decisions are politically influenced. It is true in 2002 laws established a national examination for lawyers and judges. But since judges' decisions still must be approved by the respective courts' CCP party committees, and judges are appointed and paid by the respective local people's congresses and government bodies, party as well as state bodies have considerable leeway to interfere with judicial decisions. Furthermore, lawyers also lack sufficient independence since the Chinese bar is subordinated to the ministry of justice and therefore cannot act independently.

However, there are tendencies to improve this situation; for example, since 2002 the ministry of justice has been experimenting with regulations which stipulate that provincial bar associations are divorced from the judicial administrative departments and are instead headed by practicing lawyers rather than government officials. Moreover, in the area of economic adjudication, there are indications of growing professionalism and reduced political influence. Nevertheless, even if the new Chinese leadership has pledged to give priority to counter-corruption measures, as of this writing corruption in the judicial and other sectors is rampant. As a rule, only high-profile corruption cases are prosecuted with extensive media coverage in order to substantiate the CCP and government's decidedness to reign in corruption. In contrast, the vast majority of corrupt office holders, especially at local levels, can easily escape prosecution.

1.4. Stability of democratic institutions

In the case of China, it is not possible to evaluate the stability and acceptance of democratic institutions, since at least at the central level there are no institutions that could be characterized as "democratic". Only at the local level, (the village level and with regard to residential quarters) have democratic procedures, such as elections of heads of village committees, been experimentally implemented and considered institutionalized. However, these first steps are not intended to influence developments at the central level; the new Chinese leadership made it clear that the establishment of a western-style democratic, multiparty system is not an option for China.

1.5. Political and social integration

Political parties in China are no effective means to articulate and aggregate social interests in an open and pluralistic fashion. The CCP's claim to power is comprehensive and other, so-called democratic parties do not constitute opposition to the CCP, but they are controlled and subordinated to the party. Underground opposition parties or organizations are relentlessly suppressed.

Against this background, cooperative associations and interest groups are of great importance to mediate between the political system and society. Since the beginning of the Opening and Reform period, cooperative associations and interests groups have proliferated and become more diversified. Initially, these groups mainly represented academic-scientific and economic-occupational interests. But in recent years, these groups get more and more involved with difficult social problems, working in areas such as environmental protection, representation of the interests of marginalized groups (such as women, the disabled, ethnic minorities and children) and also provide services to the population, such as legal aid and consumer protection services. Moreover, these groups also have considerable influence on the NPC by helping their specialized functional committees to draft laws and regulations. Because of the growth of the middle class, there are also recreational organizations.

However, dependent on their mission and thus the potential threat to the CCP's authority, these organizations are more or less controlled by the state, especially in the post-1989 period. The formation of trade unions unattached to the All China Federation of Trade Unions, itself controlled by the CCP, is suppressed. In recent years, sometimes-violent social unrest, mainly related to labor law disputes (unpaid wages, lack of insurance for workers and lack of compensation for occupational injuries), became more frequent, indicating the existing system's difficulties to effectively channel and settle social demands. This has considerable potential for the de-legitimization of the CCP and thus for the destabilization of China's political system as a whole.

Empirically reliable insights are not available concerning Chinese citizens' consent to democratic norms and procedures. In general terms, political and cultural premises, such as lack of traditions of liberal constitutionalism and of a positive record of political competition for power, should be considered severe hindrances to democratic transformation. Furthermore, the government's manipulation of nationalism to enhance regime support seems to have been a successful antidote to political discontent.

However, at the micro level a considerable degree of social self-organization and construction of social capital can be observed. This is especially true with regard to strong loyalties among family members, supportive to the development of family businesses. However, in recent years, in urban area organizations developed even beyond family membership. These organizations focus mainly on

mutual support among neighbors or provide charitable services. Thus, in many cases these groups fill the gaps left by the insufficient national social security system.

2. Market economy

2.1. Level of socioeconomic development

As far as central economic indicators are concerned, economic development has been successful, with average annual GDP growth rates of about 8.4% (1995 to 2003); the first three quarters of 2004 saw GDP growth of 9%. However, this impressive economic development also resulted in severe inequalities with regard to the distribution of income and property. In 2004, China's Gini coefficient was approximately 46. Inter-regional and urban-rural income disparities were considerably aggravated in recent years. In 2003, disposable income for urban residents amounted to 8,472 yuan (\$1,024) and to 2,622 yuan (\$317) for rural residents. In the first quarter of 2004, disposable incomes in urban areas increased by 11.9% and by 16.1% in rural areas. This widening income gap has to be considered a serious threat to social stability, indicated by increasing large-scale public disturbances, mainly in the countryside.

Income discrepancies also resulted in massive migratory movements, especially between rural and urban areas as well as between provinces. In 2000, the size of China's floating population, migrants without local household registration (*hukou*), amounted to 79 million; if intra-county floating migration is included as well (approximately 66 million people in 2000), the number of migrants is 145 million (2000).

Moreover, large parts of the population are excluded from the benefits of economic development, mainly due to poverty, gender and a lack of education. In 2003, the UNDP Gender-related Development Index (GDI) reached a value of 0.718.

2.2. Organization of the market and competition

Market economy competition and the development of a market institutional framework are improving slowly. However, severe problems in these areas remain.

First, urgently required liberalization measures are only selectively implemented. For example, different types of enterprises are not treated equally with regard to administrative procedures and the imposition of taxes. Furthermore, the financial system still does not allocate capital efficiently; this means that only the well-established and best-connected firms, in general SOEs, are able to raise sufficient

funds whereas many private enterprises have to rely on the black market for capital, where interest rates are often more than 20%. Government meddling still frequently meddles in economic decisions. This results in massive over-investment in some industries, mainly steel, aluminum and cement production, and property projects, haphazard investment decisions and banks overburdened by non-performing loans. Moreover, during the period of review, the economy showed severe signs of overheating; in the first quarter of 2004, industrial outputs, investment in fixed assets, bank loans, and inflation grew by 17.5%, 18.3%, 21% and 4.4%, respectively. As a counter measure, for the first time since 1995 the government raised interest rates in October 2004, lifting the benchmark-lending rate from 5.31% to 5.58%. Reserve requirements for banks have also been lifted three times since the middle of 2003. However, since the government still engages in policy lending, interest rates will only have a limited influence on cooling down the economy.

The commercialization of SOEs is a positive trend. The latest draft of the Bankruptcy Law, which is expected to be enacted in 2005, will apply equally to private enterprises and SOEs. Bankruptcies of banks and insurance companies will also be included. This will bring China closer to international standards.

Banks in China are mainly state owned and do not live up to internationally required standards of prudential regulation. Financial resources are still not efficiently allocated in accordance with market criteria. This results in large numbers of bad loans in the banking system; it is estimated that in 2004, 40% to 50% of loans, worth about \$500 billion, are non-performing. Since the Chinese central bank, the People's Bank of China (PBOC), proved unable to cope with this problem, in April 2003 the China Banking Regulation Commission (CBRC) was established. This step was aimed at streamlining the banking system, assigning the macroeconomic control function – primarily through monetary policy – to the PBOC, and giving the supervisory and regulatory function to CBRC, especially in the enforcement of Basle banking standards on commercial banks. The main task of the CBRC is to reign in over-lending and thus reduce the amount of bad loans in the banking system. The influence of the CBRC will be limited as long as lending decisions are influenced by political decisions and no strong consensus about shape of financial and banking reforms has emerged in the Chinese leadership.

As far as monopolies are concerned, competition in key industries and the public utilities sector (mainly oil and petrochemical industries, telecommunications and finance) is still not sufficient and effective due to anti-competitive business and administrative conduct. With regard to the latter, the most severe problems lie with state monopolies (for example the railway and post industries), complicated examination and approval procedures, and regional protectionism.

However in September 2004, an Antimonopoly Office was established within the Ministry of Commerce (MOFCOM) as a temporary measure; and in November

2004, China issued a first draft of its anti-monopoly legislation, intended to regulate monopoly agreements, abuse of dominant market status, large scale consolidation and administrative monopolies. Local protectionism is the most common form of administrative monopoly. However, since the draft law does not provide for the establishment of an independent watchdog to oversee its implementation, its effect on curbing local protectionism and monopoly formation is limited.

Integration into the international economic system, mainly through foreign trade and foreign direct investment (FDI), remains important. In 2004, FDI totaled \$61 billion, causing China to surpass the United States as the largest recipient of FDI in the world. However, WTO membership requires further liberalization. This increases pressure on the Chinese leadership to adjust to international economic standards and helps to remove political obstacles to the implementation of reform measures.

2.3. Currency and price stability

Since economic growth has remained strong during the period of review and is expected to continue on a high level, the danger of overheating persists. Inflation has been rather high in recent years, reaching 3% to 4% in 2004. Thus, in order to prepare for a “soft landing”, the PBOC raised interest rates in October 2004.

Macroeconomic stability is of utmost importance to the Chinese leadership, thus drastic measures to cool down the economy are not expected. This means the Chinese currency, which is still pegged to the U.S. dollar, is not expected to be revalued in the near future even if the Chinese government faces massive pressure in this regard, especially from the United States. Instead, the Chinese leadership plans to move gradually to a flexible exchange rate regime in the medium term.

2.4. Private property

Administrative bodies increasingly observe private property rights. In addition, since the most recent amendment to the Chinese constitution in March 2004, private property rights are politically regarded to be on a par with public property. Thus, when the Chinese Property Rights Law, expected to be enacted in 2005, comes into force, private property rights will enjoy constitutional and basic legal protection for the first time in China.

Even if private enterprises are important to the Chinese economy because they help stimulate growth and provide employment, they are still discriminated against, especially with regard to access to capital.

The reform of SOEs, mainly by way of conversion to shareholding corporations, and the closure of smaller companies and mergers continue.

2.5. Welfare regime

The latest constitutional amendment determined that the state establishes and completes a social security system in accordance with the current state of economic development. This reflects the Chinese government's understanding that the adverse consequences of market economic reforms are not sufficiently matched by the current welfare regime. In the countryside, 90% of the population has no health insurance; in the cities, nearly 60% are not covered. Compared with the spread of diseases such as HIV and severe acute respiratory syndrome (SARS), this situation may result in reducing the life expectancy in China. A new "cooperative medical system", established on a trial basis in the countryside after the SARS breakout in 2003 and funded by voluntary participants, local authorities and the central government, is not likely to prove successful.

The nascent Chinese pension system is also not able to provide adequate security to future generations of retirees since funding for the system is not secured and the "graying" Chinese population adds further strain on the system.

Despite reform measures aimed at bolstering the development of more remote regions, equal opportunities for citizens in all parts of China could not have been established in recent years. Access to education, social security systems and public services is only secured in coastal regions; the countryside and western regions still lack the provision of basic supplies.

2.6. Economic performance

Since the early 1980s, the Chinese economy has maintained very high annual average growth rates of about 9%. However, growth rates might be exaggerated due to inaccurate statistical data.

The same is true for the jobless rate. Official figures give a jobless rate of 4.3%. If underemployment in rural regions is included, this figure may be closer to 23%, according to American Rand Corporation estimates. This situation results in severe social and economic consequences for Chinese workers due to the lack of adequate social security systems.

In 2004, the government's budget deficit was 319.8 billion yuan (\$38.7 billion), the same as in 2003. Even if the government decided to cut the deficit in 2005, pursuing a transition from an expansionary fiscal policy to a stable one, a major reduction in spending is unlikely because of the need to support weaker areas of the economy, such as agriculture and ailing SOEs.

The main challenge for the Chinese government is to cool down economic growth, but on the other hand, to perpetuate a minimum growth of 7% a year in order to generate enough new jobs.

2.7. Sustainability

Economic growth has come with severe strains on natural resources: water and waste pollution are the most serious issues. Thus, according to the World Bank, environmental degradation is costing China an annual 8% to 12% of the GDP in direct damage, constituting a bottleneck constraining economic growth. The new Chinese leadership only recently stressed more balanced development rather than excessive economic growth and boosted environmental spending to 700 billion yuan (\$85 billion) from 2001 to 2005.

Pressure on China, both international and internal, to reduce greenhouse gas emissions contribute to these policy changes. As the material wealth of urban Chinese increases, more citizens are showing concern for the environment. The concerns of poor rural populations regarding environmental degradation have recently been picked up by proliferating green NGOs. All this increases demands on the government to improve the situation.

The government is concentrating on reforms in the education sector, too. However, the education system in China is still inadequate. According to the United Nations, China spends only 2% of its GDP on education and the government provides only 53% of school funding. However, again, a growing middle class has begun to put pressure on the government to improve educational opportunities, thus eventually encouraging progress in this area, too.

3. Management

3.1. Level of difficulty

In 2004, China had already achieved a high degree of economic transformation based on a moderate, solid level of income and education. The transformation has been quite positive due, for example, to the lack of ethnic conflicts on a national scale, economic reform potential and the ability of the CCP to handle crises effectively. However, significant sections of the population are still excluded from the benefits of transformation due to poverty and persistent regional inequalities. Nevertheless, important and difficult reform measures need to be implemented in the future, which have the potential to jeopardize the transformation process. As of this writing, financial sector reforms lag behind, and banking system reforms and privatization constitute the main challenges because they require a political readjustment. Furthermore, privatization of SOEs will involve massive layoff of

workers, leading to social instability because of the lack of welfare benefits and protection. All this has the potential to challenge the legitimacy of the CCP and thus to jeopardize the Chinese leadership's management performance. Rampant corruption and the resulting lack of popular trust in CCP cadres add to this problem.

There is potential for uncontrolled social discontent because there is no tradition and only nascent signs of the development of civil society, which could provide mechanisms for channeling popular dissatisfaction.

Profile of the Political System

Regime type:	<i>Autocracy</i>	Constraints to executive authority:	<i>1</i>
		Latest parliamentary election:	<i>17.03.2003</i>
1. Head of State:	<i>Jiang Zemin</i>	Cabinet duration:	<i>03/98-03/03</i>
Head of Government:	<i>Zhu Rongji</i>		
2. Head of State:	<i>Hu Jintao</i>	Cabinet duration:	<i>03/03-present</i>
Head of Government:	<i>Wen Jiabao</i>		
		Number of ministries:	<i>28</i>
		Number of ministers:	<i>10</i>
Source: BTI team, based upon information by country analysts, situation in July 2005. Constraints to executive authority (1-6 max.) measures the institutional constraints posed by a federal or decentralized state, a second parliamentary chamber, referenda, constitutional and judicial review and the rigidity of the constitution. Number of ministries/ministers denotes the situation on 1 January 2005.			

3.2. Steering capability

The main priority of the Chinese leadership is to maintain macroeconomic stability. In general, required reforms and measures have been implemented stringently, even against tough internal pressure. Due to the absence of strong, organized social interest groups, the government has been able to implement policy decisions, even those with severe negative consequences for some parts of the population. However, the population increasingly defies local and even central government decisions if these severely compromise their interests, more often than not resulting in these decisions being revoked. This indicates a creeping loss of steering capacity, at least at the local level, as well as a growing popular determination to strive for popular interests, often with the support of the media.

As far as the social costs of transformation are concerned, the Chinese leadership seems to have noticed that some parts of the population may fall behind and recognizes the resulting potential threat to the legitimacy of the CCP. Thus, the Chinese leadership adopted the latest constitutional amendment to broaden its legitimacy; it establishes the CCP as a catchall party in order to embrace the developing middle classes and private entrepreneurs. Furthermore, the new political leadership strives to pay more attention to the rural population, who has lost out during the transformation process. However, to date there is no clear

policy line to improve the situation of the rural population. If the new political leadership should not be able to live up to the promises it has made, this could result in difficult tensions with the rural population and a large-scale loss of confidence in the government.

Furthermore, the Chinese leadership has recognized that economic transformation has to account for the preservation of natural living conditions. Therefore, the government has started to pay more attention to the problem of environmental degradation; however, a clear-cut policy has not been considered.

3.3. Resource efficiency

During the transformation process, many resources were not used efficiently because political considerations prevailed over macroeconomic necessities. This is especially true with regard to the reform of SOEs and the need to support weaker areas of the economy, such as agriculture, public utilities and strategic raw materials. Furthermore, efforts to restructure SOEs resulted in the large-scale socialization of losses due to a lack of procedural transparency. On the whole, the overall budget deficit increased during the period of review, amounting to \$38.7 billion in 2004. Thus far, the government faces difficulties in coordinating two main conflicting economic policy objectives: on the one hand, the need to reign in deficit spending by ceasing support for loss-making areas of the economy, and on the other hand the need to create new employment opportunities and to protect existing jobs in these areas through public spending. Since the legitimacy of the ruling CCP is tied to the welfare of the population, it is likely that political considerations will prevail over necessary macroeconomic reorientations.

Budgetary processes are still complicated and lack transparency. Thus, the effective use of fiscal resources is hampered and difficult to control. Corruption is still widespread. However, recently, the National Audit Administration received considerable political backing in its fight against the misuse of public funds and proved to be more successful in the fight against corruption. Moreover, the Administrative Licensing Law, which took effect on July 1, 2004, aims to eliminate opaque processes at the local level regarding business licenses and project approvals.

Efforts to streamline bureaucratic structures and to increase the efficiency of the administration are still under way. One major improvement in this regard is the creation of the new MOFCOM in 2003 as a merger of the former State Development and Planning Commission and the Ministry of Foreign Trade and Economic Cooperation (MOFTEC).

3.4. Consensus-building

The Chinese leadership adheres to the aim of building up a socialist market

economy, even if there are competing views as to the concrete design of this economic order. Bargaining processes aimed at integrating these competing views and potential veto actors have so far been successful; but, as a rule, these processes are conducted by internal CCP bodies and thus cannot be retraced by outside observers.

With regard to further political development, the new Chinese leadership, too, rules out transformation to a multiparty, democratic political order. Any form of organized political opposition is subject to consequent suppression. However, especially with the spread of the Internet, the space for the articulation of public discontent is growing. As long as these forms of public protest remain limited in scope, unorganized and do not directly challenge the CCP, the Chinese leadership tolerates the phenomenon as these debates also serve as a valve for social tensions. Occasionally, the media has covered demonstrative causes for public grievances. In some cases, most prominently with regard to the abolition of the Custody and Repatriation system in summer 2003 but also with regard to some resettlement cases, public pressure induced the government to revoke disputed measures. However, if protest seems to grow out of control, the Chinese political leadership remains in a position to crack down on public demonstrations quickly and effectively.

Even if the course of economic reform has become subject of a relatively broad social discourse, public opinion can hardly influence political decisions in this area; CCP bodies take these on internally. The CCP is not prepared to deal constructively with political opposition, which is suppressed instead. This posture so far guarantees a considerably high degree of assertiveness and ability to make long-term policy decisions. Although a high degree of political stability could have been maintained, the CCP remains the most relevant anti-democratic actor in the Chinese political system.

The inability and unwillingness of the CCP to deal constructively with public dissatisfaction also has potential to for future political instability. Continuing economic modernization and societal pluralization also result in the development of new social cleavages. The cleavages most prominent occur between the highly developed eastern coastal regions and the western parts of China, and between the growing urban middle classes and the rural population. At the 16th Party Congress in 2002, the CCP performed an ideological transformation from a class-based party to a catchall party, intending to unify different societal strata and interests under the leadership of the CCP. Furthermore, the new Chinese leadership made the improvement of the rural population's economic situation a priority. However, it remains to be seen whether the new leadership succeeds in unifying society and thus, consequently, in ensuring political stability as a vital precondition for further development.

Social capital is slowly developing. As long as citizen engagement is limited to special areas, such as environmental protection, neighborly aid, and charity, the

government welcomes these activities because they complement public services, which are often insufficient. However, if civic engagement takes a decisive political stance, activities are regularly suppressed as illicit political opposition.

3.5. International cooperation

China still maintains and expands cooperative ties with external actors such as the IMF, World Bank and Asian Development Bank in order to obtain support for its ongoing economic reform process. Recently, technical cooperation with western nations and international actors has increased significantly, mostly in the area of law, in order to improve its implementation of WTO rules. China still receives the highest amount of official development assistance (ODA) in the region. Moreover, the government generally succeeds in channeling western ODA into areas where resources are used mostly efficiently and in support of the transformation process. However, technical cooperation in legal and judicial reforms and village elections has not induced processes of democratic transformation, as far as the influence of foreign development cooperation on China's political development is concerned. Due to the status of China as an important trade partner for western nations, the government savors a strong negotiating position in international cooperation. This means China is also in a position to reject cooperation proposals, which are considered intrusions into internal Chinese affairs.

China has evolved into a generally reliable member of the international community and a mostly dependable partner in bilateral relations with the continuous integration into international organizations. However, certain sources for conflict with individual partners and with the international community remain, most importantly with regard to the Taiwan question, continuous human rights violations and the proliferation of weapons of mass destruction. In particular, China's bilateral relationship with the United States remains tense. However, new factors for cooperation and consent have emerged which are conducive to their relations, thanks to the government's willingness to participate in the fight against terrorism.

Cooperation between China and East Asian nations, especially with ASEAN, has further improved. In November 2004, China signed an agreement with ASEAN on the development of a free trade area. Minor tensions, mainly with regard to territorial disputes, remain but due to the importance of economic cooperation, these do not exert a major negative influence on ASEAN-Chinese relations.

Due to its successful economic development and capacity, China has achieved international acceptance and equality in all major fields of cooperation. Furthermore, all important decisions on such diverse subjects as environmental protection, security policy and economics have to take into account the position of the Chinese government and in most cases require its consent in order to become

effective.

4. Trend of development

4.1. Democratic development

There have been no significant improvements to democratic development in China during the period of review. Stateness has not eroded, and it is not endangered. Venues for political participation are still very limited and subordinate to the CCP's exclusive claim to power. The Chinese government strictly rejects transformation toward a multiparty, democratic political system.

However, as positive trends go, one has to point out the stability of the political system even after the new fourth generation leadership came to power. Furthermore, the new leadership seems to become gradually more receptive to public demands than the previous one. Adverse social consequences resulting from economic modernization increasingly constitute a challenge to the Chinese leadership's legitimacy, but the government has begun to address the most severe problems such as social inequality, development disparities, environmental degradation and health care problems. If the government copes with these problems successfully, stability can be achieved in the long term.

Mainly due to WTO obligations, reforms to the rule of law are enforced increasingly more insistently. In this regard, the rule of law situation in main economic sectors can already be regarded as satisfactory; however, reforms in remote and rural areas are still lagging behind and need further improvement.

4.2. Market economy development

Macroeconomic fundamentals improved significantly during the period of investigation. This is most obvious with regard to the HDI, which increased from 0.701 in 1997 to 0.745 in 2002. However, this development is also accompanied by increased social inequality; in 2004, the Gini coefficient rose to 46.

So far, the general economic framework proved stable and the management of economic transformation was not adversely affected by the change in Chinese leadership. The government at large is in control of macroeconomic steering and recently successfully retarded further disproportionate growth of the economy.

The institutional framework for market-based action also improved with the evolution of increased legal protection of private property rights and further positive developments in commercial rule of law.

However, the new Chinese government continues to be confronted with certain severe macroeconomic flaws, which so far have not been solved successfully and according to economic exigencies are mainly due to political considerations. Most notable are reform deficits in the financial and banking sectors and the

restructuring of SOEs. Furthermore, severe inequalities in regional development persist and even increased during the period of review. In the medium to long term, these problems have the potential to derogate the stability and sustainability of economic development.

Table: Development of macroeconomic fundamentals (2000-2004)

	2000	2001	2002	2003	2004
Growth of GDP in %	8.4	7.2	8.5	9.1	9.7 (est.)
Export growth in %	27.8	6.8	22.3	34.6	35.5 (est.)
Import growth in %	35.8	8.2	21.2	39.9	41.3 (est.)
Inflation in % (CPI)	0.4	0.7	-0.8	1.2	3.6 (est.)
Investment in % of GDP	36.3	38.5	40.4	44.4	n.a.
Tax Revenue in % of GDP	15.3	n.a.	16.7	18.7	n.a.
Unemployment in %	3.1	3.6	4.0	4.3	n.a.
Budget deficit in % of GDP	-2.78	-2.54	-2.95	-2.49	-3.0 (est.)
Current account balance in billion \$	20.518	17.401	35.422	45.875	n.a.

Source: ADB; NBS; World Bank; SCMP

D. Strategic perspective

Even if the economic transformation of China has in part proved successful, severe structural problems and risks to the economic realm persist. Partly because of political and ideological constraints, the Chinese leadership has not elaborated adequate solutions to these problems. The most prominent include: reform of the financial sector, restructuring of SOEs, environmental degradation, lack of sufficient social security mechanisms and growing regional disparities.

Insufficient restructuring and privatization of the state-owned sector and the lack of adequate social security systems are interrelated. This means external support, for example legal cooperation, should be directed at supporting the Chinese leadership with the quick development of a social security system that matches the specific conditions in China.

For different market actors, inadequate financial sector reforms and resultant unequal access to capital impose a burden on economic development because capital is not channeled to the most productive areas of the economy. One has to bear in mind that there is a need for high economic growth in China in order to create jobs. This means that the private sector should have greater access to capital in order to fulfill their full potential for growth. However, there are no decisive efforts to reign in the close interweaving of political and economic elites constituting the main cause of the problem. Therefore, prospects for reforms and improvements in this area remain largely uncertain.

Furthermore, environmental degradation and its consequences constitute a severe burden for economic development. The Chinese leadership lacks the resources and political will to introduce fundamental reforms to the energy and other resource pricing, as well as to the emission control regime. External advice, for example with regard to the regulation and modernization of urban traffic, and technology transfer could prove helpful by gradually improving the environmental situation. External pressure, too, can prove conducive since, as has been the case with reforms in connection with the accession to the WTO, reformist forces can instrumentalize external demands as viable arguments to push for reform.

The tasks ahead demand a high degree of steering capability. However, growing social problems increasingly challenge the legitimacy of the ruling CCP. The new Chinese leadership has detected the dangers ahead and initially made welfare and regional development concerns a priority. However, this implies the danger that the political leadership may not be able to fulfill all expectations, thus further eroding the party's legitimacy. On the other hand, radical reforms will surely challenge vested interests; thus it remains to be seen whether the new political leadership can rally enough internal support in order to implement needed reforms.

In the case of WTO membership, it has become clear that international (economic) integration can induce positive changes in China, for example with regard to the (commercial) rule of law. This means, China's international integration should be increased in other areas as well, since the Chinese political leadership is able and – in certain spheres – willing to adapt to international standards.

Overall, the success of the Chinese economic (and more so the political) reform process has to be regarded as uncertain. The ability of the new political leadership to secure stability and to implement needed reforms will be decided by future developments.