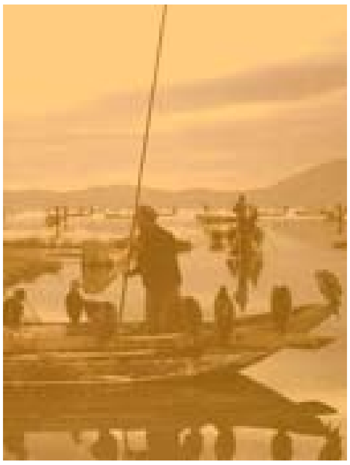
3

CHAPTER 3

A Contradictory Reality

3 A Contradictory Reality



3.1. Building the myth of China

The purpose of this chapter is to establish the context for a proper understanding of China's socio-economic situation and its possible impact on any new global balance.

There are many preconceptions in the West about this country and the events currently taking place there. We only ever hear that China is vast, a giant, the Number One... And also that it is a single, uniform, country, with a single type of people, a single language and a single, ancient, culture.

Another misinformed preconception is that it is a classless society, a legacy of the communist era, with a population that cannot tell-and doesn't care-the difference between good and bad quality. And of course its economy is generally believed to be very tightly controlled by the government and very centralised. The final preconception has to do with trading relations between the European Union and China. People say that China is interested only in price: everything is so cheap that it is impossible to compete with its prices; it is destined to become the "factory of the world" and it doesn't care about intellectual property.

This is probably a fair summary of the main preconceptions about China. Let us now address them one by one. In this chapter, the Fundación de la Innovación Bankinter offers an analysis of the macroeconomic figures which have helped build the "China myth", the basic overall outlines and then the nuances that reveal a more complex reality, which better matches the situation that businesspeople and entrepreneurs need to take into account in their decision-making.

3.1.1. Key macroeconomic figures

Statistics shows that the Chinese economy has seen sustained growth for the last fifteen years. The demographic giant has now become a global economic power. China's GDP in 2004 came to 1.627 trillion dollars[1], up 9.5% on the previous year. At the beginning of this year the World Bank predicted that the growth rate for 2005 would be 8.3% which, although still considerable, evidences a certain slowdown. It is even possible that the figure at 31 December will be somewhat below 8%.

Due to the particular idiosyncrasy of China and its incomparable demographic potential, these macroeconomic figures have caught the world's attention. The country is seen as some voracious animal, an insatiable consumer of resources. China is now the world's leading consumer of strategic products and raw materials (with the exception of oil, in which it is only exceeded by the US). Its move towards a fully capitalist economy appears unstoppable and few experts would dare to set limits to its growth.

1. This is the "official" figure - i.e., the figure published by the Chinese government using the current exchange rate for the Yuan. However, the figure is far more spectacular if we base the exchange rate on purchasing power parity. In this case, the People's Republic of China emerges as the world's second largest economy behind the US, with a GDP of 7.2 trillion dollars (Source: CIA, The World Factbook).

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Because of China's vast impact on the world economy, this document will seek to examine not only its past, but also its immediate future and try to draw up certain growth hypotheses for the country. The first sections below will examine in greater depth other domestic data reflecting the development of the Chinese economy. In this first part, we shall also take a look at some key macroeconomic figures from an objective perspective, with particular stress on foreign trade and foreign investment in the country.

3.1.1.1. Sustained growth in GDP

Since 1989, when the events in Tiananmen Square led to an acceleration in the opening up of its economy, China has grown rapidly. Indeed, since 1991, GDP has grown by over 7% per year every year, putting the Chinese economy among the fastest-growing economies in the world.

In absolute terms, as we have already seen, GDP came to over $1.6 trillion in 2004. In perspective, this figure means that China is now the world's seventh largest economy. However, as we can see from Table 1, the country still has a lot of ground to catch up in terms of income per capita. In 2004, the average Chinese citizen enjoyed an income of 1,250 US dollars, compared, for example, to a US average of $40,100 or a European figure of $27,000. In context, this figure reflects China's huge potential for growth before its reaches per capita income levels similar to those of OECD countries.

Comparison of Gross Domestic Product.

Country	GDP	Percentage of World GDP	PIB - per capita	Date of information
World	$ 55.500.000.000.000	100	$ 8.800	2004 est.
United States	$ 11.750.000.000.000	21,1	$ 40.100	2004 est.
European Union	$ 11.650.000.000.000	20,9	$ 26.900	2004 est.
China	$ 1.600.000.000.000	2,9	$ 1.230	2004 est.
Spain	$ 937.600.000.000	1,7	$ 23.300	2004 est.

Source: The CIA Factbook, 2005 and the EU's External Relations Department.

Notes

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The clearest example of this rapid growth in Chinese GDP can be seen in the dramatic increase in the components of domestic demand. Imports and exports (which will be dealt with in a separate section) have risen spectacularly for several years. Likewise, capital investment in fixed assets, which still faces something of a deficit, has increased exponentially over recent years.

Growth in components of demand in China.

	2000	2001	2002	2003
Investment in fixed assets	9,7	12,1	16,1	26,7
Bank credit	13,4	11,6	15,4	21,0
Retail sales	9,7	10,1	8,8	9,1
Exports	27,8	6,8	22,3	34,7
Imports	35,8	8,2	21,2	39,9

Source: Pablo Bustelo, http://rcci.net/globalizacion/2004/fg475.htm

3.1.1.2. Other macroeconomic indicators

Despite this sustained increase in activity, Chinese public authorities have managed to keep inflation under control. A moderate increase-3.5%-is predicted for 2005, although, as we shall see, there are already signs of an overheating of the economy.

Comparative rates of inflation

Ranking	Country	Rate of inflation (consumer prices) (%)	Date of information
5	Hong Kong	-0,30	2004 est.
64	European Union	2,10	2004 est.
82	United States	2,50	2004 est.
106	Spain	3,20	2004 est.
133	China	4,10	2004 est.

Source: *The CIA Factbook*, 2005.

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In the light of the good inflation figures, it would be reasonable to presume from the Philips curve that there should be high unemployment. However, this is not the case: the level of unemployment officially recognised stands at very similar levels to the European Union.

According to official statistics, unemployment is almost entirely limited to rural areas. This is due to the fact that industrial development has reduced urban unemployment practically to zero, although there is a growing gap between town and country, favouring a massive rural exodus towards the cities in recent years.

In any case, the Chinese government's figures have been called into question on occasions, not only because of the lack of transparency inherent to a single-party system, but also because of the intrinsic difficulty of monitoring such an immense mass of population. The CIA, for example, estimates that real unemployment rates stand at around 20% of the workforce, and this, given the vast labour mass of the country, will be one of the most difficult challenges facing the Chinese communist party over coming years.

Comparison of unemployment.

Ranking	Country	Unemployment rate (%)	Date of information
3	United States	5,50	2004 est.
7	Hong Kong	6,70	2004 est.
86	European Union	9,50	2004 est.
89	China	9,80	2004 est.
96	Spain	10,40	2004 est.
171	World	30,00	NA

Source: *The CIA Factbook*, 2005.

Accelerated economic growth has necessarily been accompanied by an increase in foreign debt, but this still stands at much lower levels than Europe or the US, suggesting that there is still capacity for external financing of China's future growth. Nonetheless, the country's foreign debt has grown at a rate of 15% per annum in recent years.

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Comparison of levels of foreign debt

Ranking	Country	Foreign debt	Date of information
1	World	$ 12.700.000.000.000	2004 est.
3	United States	$ 1.400.000.000.000	2004 est.
5	Spain	$ 771.100.000.000	2004 est.
7	Hong Kong	$ 417.600.000.000	30 June, 2003 est.
10	China	$ 233.300.000.000	3rd Quarter 2004

Source: *The CIA Factbook*, 2005.

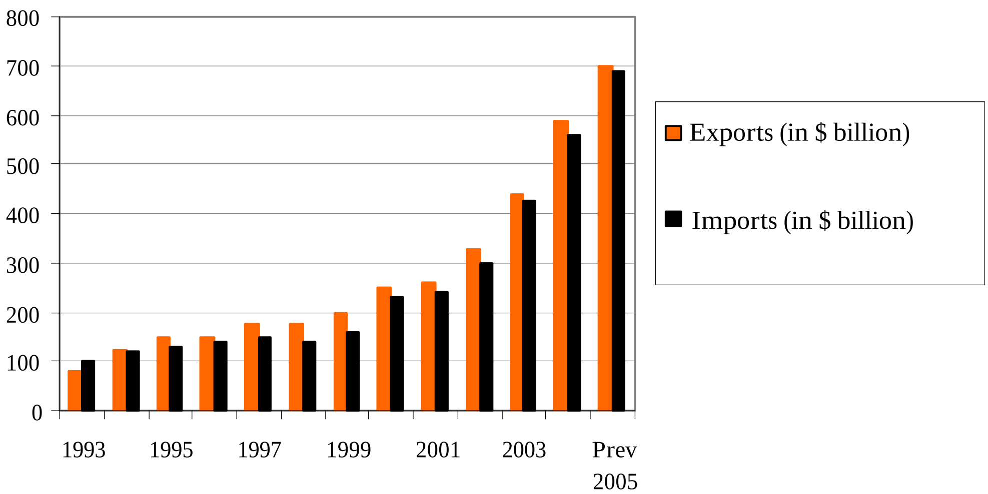
3.1.1.3. Acceleration and reorganisation of foreign investments

- Imports and exports

Another important indicator of China's growth in recent years is the exponential increase in its exports and imports.

During 2004, exports again grew by 35.4%, to 593,400 million dollars, while imports rose 36%, to 561,400 million dollars.

Trends in Chinese foreign trade.



Source: Own preparation based on data from the National Bureau of Statistics.

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The upward trend in imports is a result of strong demand for the raw materials-especially oil, soy and iron ore-needed to power an economy that grew at a rate of 9.5% in 2004. China already covers 40% of its needs from abroad and has become the world's third largest importer (after the US and Japan). It is now the world's largest consumer of cement (47% of the total world share), steel and nickel (25%) and aluminium (21%), and the second-largest oil user (7.7%). This increase in imports on such a scale is unquestionably pushing up prices for raw materials on the world market.

Amongst China's largest exports are textiles and garments, electronic products, metals, petrochemicals, wood and paper. Its main markets are the United States (21%), the European Union (18%), Hong Kong (17%) and Japan (12.4%).

China's recent entry into the WTO and the lifting of quotas on the textile industry from 1 January 2005 have raised hackles between China and its main trading partners (the United States and the European Union), as it is expected that by 2010, Chinese textile imports will account for a third of the world total, representing up to 80% of US textile imports.

To allay the fears of the United States and the European Union, on 20 May, China announced that it would raise export tariffs on 74 categories of textile products from June, representing the levying of an average tariff of 1.3%. However, in the same month, the United States announced the establishment of growth quotas on imports of certain textiles from China and set a cap of 7.5%. This hardly came as a surprise, given that in the year so far, Chinese imports had risen by 54%.

Around the same time the European Union threatened China with similar measures, although it seems that in this case China came to an agreement with Brussels to impose its own limit on textile exports to Europe of 12.5%. However, the issue of Chinese textile exports is in a state of constant flux. In August, for example, millions of T-shirts, jerseys and trousers from China were held up at European Union borders because exports of these products had already exceeded the agreed annual quota. Trading relations have still not returned to normal, and it is forecast that the negotiations following termination of the multifibre agreement will continue developing.

Notes

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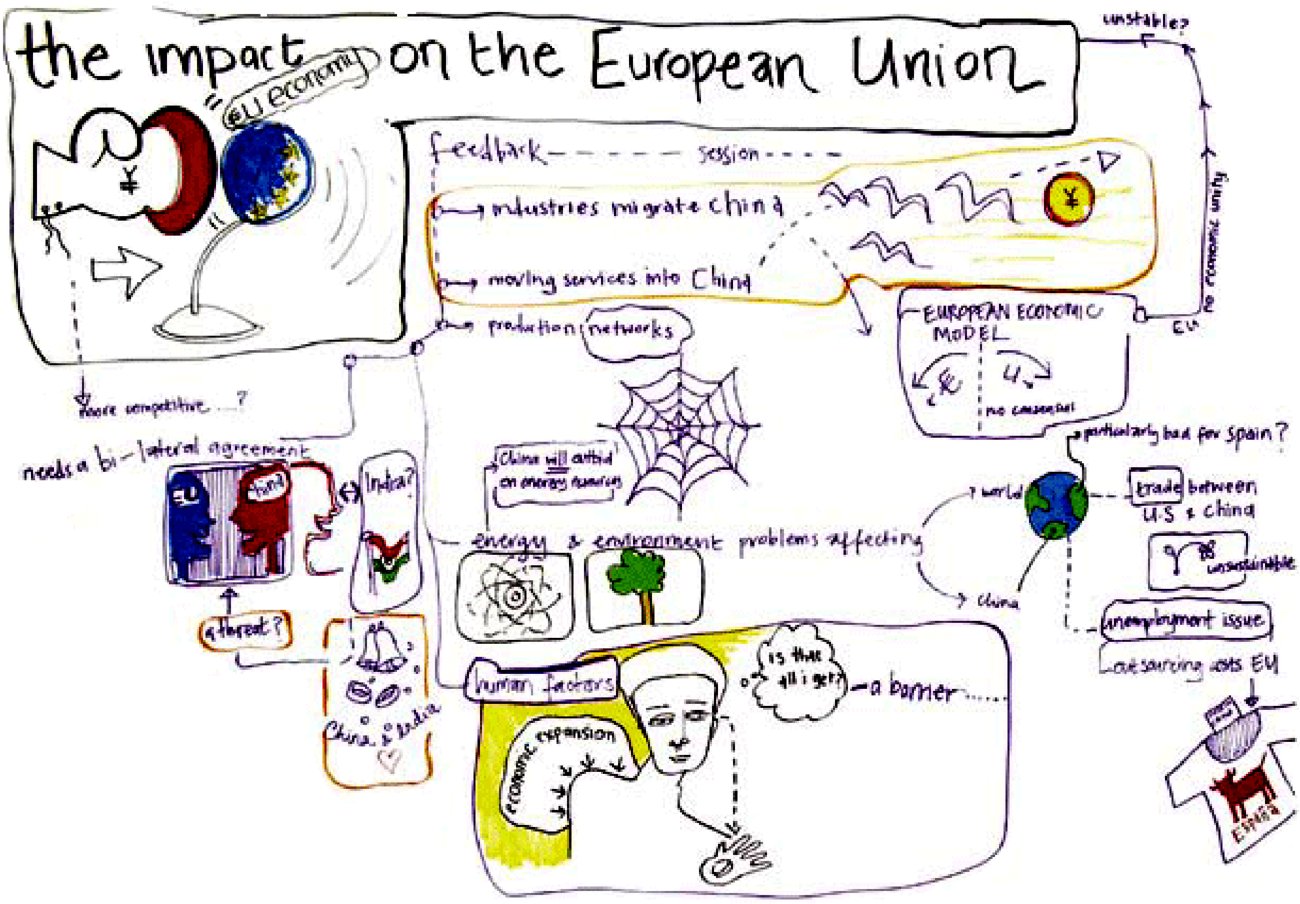
Impact for the EU



Source: Fourth FTF Meeting.

3.1.1.4. Liberalisation and reorganisation of foreign investments

- Liberalisation

China's policy of opening up to the exterior since 1978 involves transition from a centralised economy to a mixed one, in which the market is playing an increasingly central role. Actions in the area of trade policy, especially with regard to the promotion of foreign investment, the lowering of import duties on intermediary goods and reforms in state companies, lie at the heart of the boom in China's foreign investments. China's appeal for foreign capital has increased constantly, and by 2002 it had outstripped the United States in absolute terms. This year, foreign investment in China represented nearly 10% of the world total.

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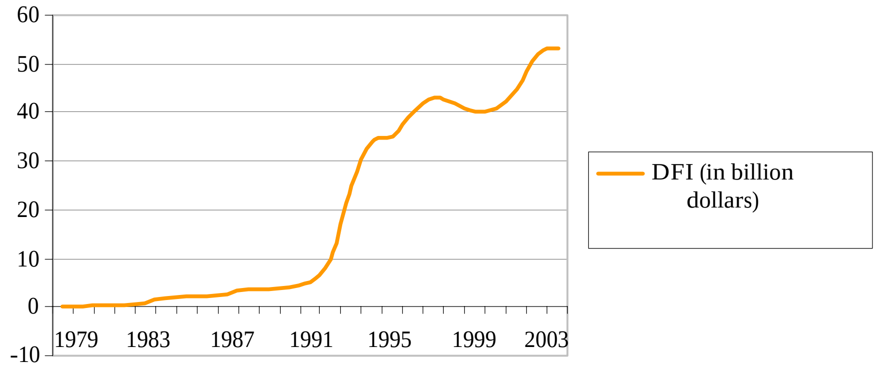
Flows in direct foreign investment and global percentage (in billion dollars).

	1985-1995	1997	1998	1999	2000	2001	Forecast 2000
China	11,7 (6,45&)	44,2 (9,25%)	43,8 (6,30%)	40,3 (3,70%)	40,8 (2,73%)	46,8 (6,37%)	52,7 (9,88%)
United States	44,4 (24,54%)	103,4 (21,63%)	174,4 (25,12%)	283,4 (26,04%)	300,9 (20,17%)	124,4 (16,93%)	44 (8,24%)
SE Asia	29,8 (16,48%)	96,3 (20,15%)	86,3 (12,42%)	100 (9,19%)	131,1 (8,79%)	94,4 (12,84%)	-
Developing Countries	50,9 (28,11%)	191 (39,96%)	187,6 (27,02%)	225,1 (20,69%)	237,9 (15,95%)	204,8 (27,86%)	-
World	181,1	478,1	694,5	1088,3	1491,9	735,1	534

Source: *http://www.tdctrade.com/econforum/boc/boc030101.htm*

Direct foreign Investment increased at a constant rate until the late 1980s. With the impetus to economic reforms resulting from the events of 1989, China multiplied its capacity to attract foreign capital, reaching a figure of $50 billion by 2002.

Direct foreign investment in China.



Source: *McKinsey.*

Reorganisation of foreign investment

Apart from the volume of investment attracted, one of the great differences between the foreign investment of the early 1990s and the existing situation lies in the source of the funds. In the 1990s, investment came mainly from China's Asian neighbours, especially Hong Kong, Taiwan and Singapore.

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Over the last five years, financing has come mainly from the United States, Japan and the European Union.

Origin of DFI funds in China (as a percentage).

Ranking	1991	1995	1999
Total	100	100	100
Hong Kong	55,3	53,4	41,0
Japan	13,1	8,5	7,2
Taiwan	10,1	8,4	6,5
United States	7,1	8,2	9,9
European Union	5,7	5,7	11,0
Singapore	1,2	4,9	6,2
South Korea	0,0	2,8	3,0
Others	7,5	8,2	15,1

Source: *China Statistics Annual China.*

3.1.2. Monetary policy (fluctuation of the Yuan)

On 21 July of this year, China decided to abandon the parity rating it had held against the US dollar since 1994 and begin using a flexible exchange rate. The new fixed band that has been approved is 8.0856 - 8.1343 Yuan to the dollar, representing a revaluation of approximately 2% in the Chinese currency. Although the new band still has only a very narrow margin of fluctuation-0.3%-this move is seen as a first step towards an increasingly flexible monetary mechanism.

This measure, which the world's media has interpreted as a victory for the American administration, is also seen as the first acknowledgement by the United States of China as an economic power and its main trading rival. For over a year, the United States has been calling on the Chinese government to revalue the Yuan to help alleviate the largest trade deficit in US history.

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China has always been reticent to float the Yuan, given the success of its economic growth over the last decade and the stability that the fixed exchange rate had brought. Indeed, it had helped it to escape practically unscathed the Asian crisis of the late 1990s, which caused serious financial waves on the markets of its nearest neighbours in South East Asia and Russia. China had been using around $200 billion a year to maintain the fixed exchange rate, representing 12% of its GDP and nearly a third of its 600 billion dollars reserves.

On this occasion, however the Chinese government chose to cash in on the most immediate returns that revaluation of the Yuan held out:

- The massive increase in Chinese demand for raw materials in recent years has pushed up their price on global markets. Because the main raw materials China needs are all imported-including crude oil, whose benchmark price is quoted in American dollars-a revaluation of the Yuan partially helped offset the price increase.

- Excessive flows of foreign investments to China favours sustained economic growth in the short term, but may create distortions in certain industries in the medium term (for example, a property bubble or a fictitious revaluation on stock markets). With a record level of dollar reserves-over $600bn-China may be considering a slowdown in the influx of foreign capital through the revaluation of its currency.

- A reduction in the American trade deficit will cause a reactivation of the American economy and possibly that of other developed countries (including the economies of South East Asia). In the long term, an increase in consumption and the resulting monetary revaluation will more than make up for the short-term reduction in Chinese exports

- Fluctuations in the Yuan allow the central government to take control of domestic monetary policy, with reduced inflationary pressures, more stable interest rates, political and institutional stability and, as a result, greater opportunity for sustained growth.

- Finally, a flexible exchange mechanism will make it possible to free up the two hundred billion dollars a year ($206,300,000,000 in 2004) that the Chinese government has been using to prop it up and which can now be invested in infrastructures and education.

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Are these the reasons that led the Chinese government to this overnight sea change in a monetary policy that had proved so successful? One might also wonder whether the new role of China as a central member of the WTO or the acknowledgement of its position as the great emerging economic power might not have played an equally important role in their decision. Complying with American wishes, with this measure China has set the precedents for a new world economic balance in which it is playing in the same league as the United States. At the same time it is also nudging Europe and, above all, Japan, its great historical rival, out of the new political and economic order imposed by globalisation.

3.1.3. Demographics and education

3.1.3.1. Demographic figures

China is the most heavily populated country in the world (and the fourth-largest in terms of land area), with about 1.3 billion inhabitants-one fifth of the world's population.

Comparative population figure for various countries.

Ranking	Country	Population	Percentage of population	Percentage of population
1	World	6.446.131.400	100	July 2005 est.
2	China	1.306.313.812	20,3	July 2005 est.
4	European Union	456.953.258	7	July 2005 est.
5	United States	295.734.134	4,5	July 2005 est.
31	Spain	40.341.462	0,6	July 2005 est.

Source: *The CIA Factbook*, 2005

As is the case in other countries, however, the Chinese population is not distributed evenly throughout the national territory. The most easterly provinces have a much higher population density: despite a smaller land area, these provinces have the highest populations.

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Population density by province
(in million inhabitants).

Source: McKinsey Analisys, 2002.

Notes

In a list of the world's most populated cities2, Shanghai comes sixth, with more than 14 million inhabitants, while Beijing (12 million), Tianjin, Hangzhou, Hong Kong, Shenyang, Changchun and Harbin are all in the first fifty, all with over 5 million inhabitants.

Despite the legendary longevity of its inhabitants, China is still a young country. It does not suffer the same problem of an ageing population as Europe does.

Fertility rate in China: total number of children per woman.

Decade	Average children per woman
1950-1959	5,88
1960-1969	5,68
1970-1979	4,01
1980-1989	2,48
1990-1999	1,98

Source: *International Monetary Fund*

2. Véase http://worldatlas.com/citypops.htm

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Fertility rates have been dramatically reversed in China. The total fertility rate, the rate of births and deaths, and the natural growth rate have been gradually decreasing for the last fifty years. Specifically, the mortality rate fell to the mid-1970s. The birth rate saw a slight growth in the 1960s, but after the 1970s, the fall in both indicators has been constant.

Despite this trend, in the 1990s the government established a very strict policy on birth control, which has been widely criticised in the West: it decided to set a limit on the number of children each couple could have. As a result of social pressure, many couples preferred their only child to be a boy-seen as being much more valuable than a girl-leading to the selective abortion of thousands of baby girls or their abandonment in orphanages. The problem has reached such a scale that in coming years China will face an imbalance in its demographic curve, with a much higher number of males than females.

Today's fertility rate affects the population of the future in two aspects that have a direct impact on the economy: the number of inhabitants and the demographic structure. Today, China has an abundant labour force to tend to its economy.

Comparison of the available labour force in different countries.

Ranking	Country	Labour force	Date of information
1	China	760.800.000	2003
3	European Union	215.000.000	various
4	United States	147.400.000	2004 est.
27	Spain	19.330.000	2004 est.

Source: *The CIA Factbook*, 2005.

3.1.3.2. Education figures

The Chinese Communist Party is aware that the future lies in the education received by the new generations, and is paying great attention to this issue. The country now has a very low illiteracy rate, with 90% of the population able to read and write.

It is particularly revealing to match demographic figures and education figures: in the medium term, there is an exponential increase in the number of Chinese university graduates compared to the rest of the world.

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Number of university students in China, United States and Spain. (Students registered at a centre of higher education/university)

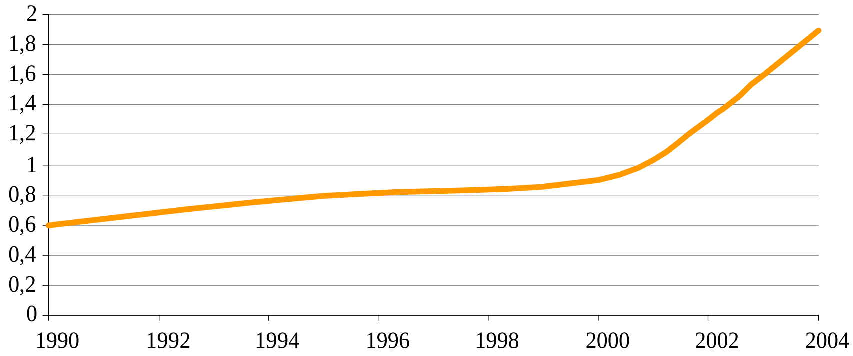
	1998/1999	1999/2000	2000/2001	2001/2002
China	6,365,625	7,364,111	9,398,581	12,143,723
United States	13,769,362	13,202,880	13,595,580	15,927,987
Spain	1,786,778	1,828,987	1,833,527	1,832,760

Fuente: *The CIA Factbook*, 2005.

In order to enter higher education, students must pass a university entrance test, after which they can choose from a range of different types of degree and diploma courses. Most Chinese students opt for a public university, with private universities mostly catering to students who did not get past the screening process for the public universities as well as students in employment who can afford the tuition fees.

Number of university graduates in China.

Students in master's courses (millions)



Source: *McKinsey: Checking China's vitals.*

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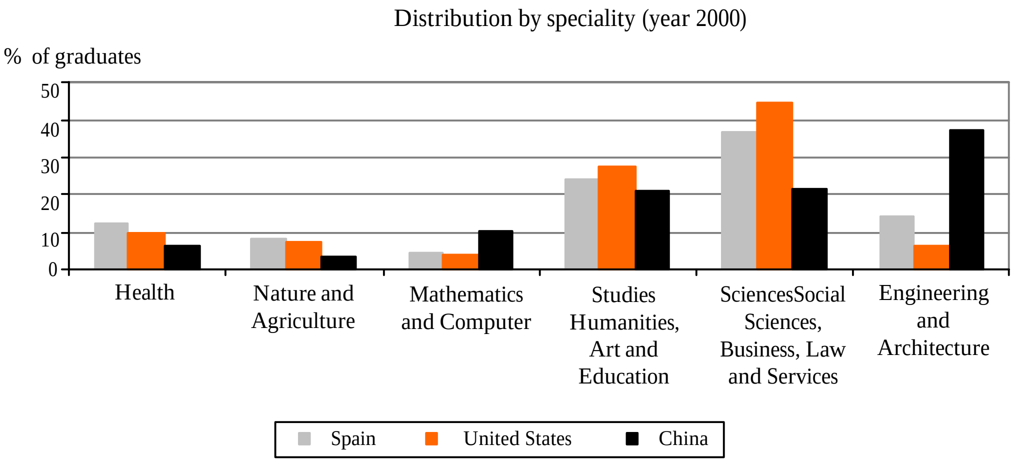
Table 16 compares the percentage of graduates in different areas of study in China, Spain and United States. It is particularly worth noting the figures for engineering students in China (354,291 according to data for 2000), which in both relative and absolute terms was well above the United States (which had fewer than 200,000 for 2001-2002).

Comparative figures for percentage of students by speciality in United States, China and Spain.



Source: Own preparation based on data from the Spanish Ministry of Education and the University of Michigan's *China Data Center*.

The increase in university students has also led to an exponential increase in the number of students in postgraduate studies, considered to be the breeding ground for China's future political, business, cultural and scientific leaders. The growing academic level in national universities also manages to retain intellectual capital in the country, whereas in the early 1990s, many PhD students chose to study in the United States.

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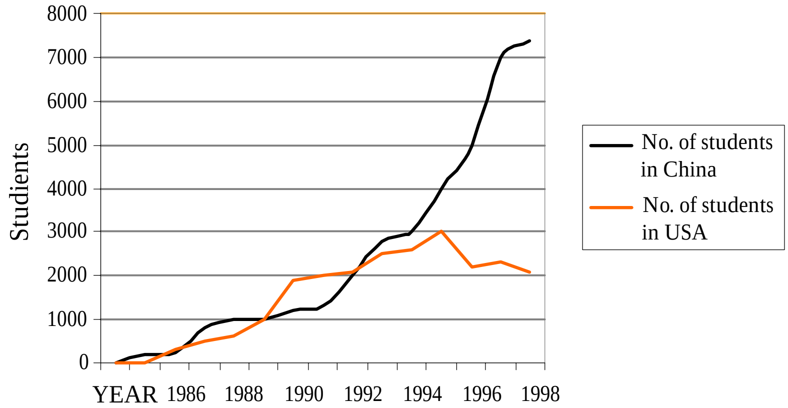
The Learning Curve of Chinese Students.



Source: Fortune Magazine.

3.1.4. Energy resources

3.1.4.1. Energy crisis

Sustained growth in economic activity over the last decade has led to a major increase in China's energy needs. Energy, as the powerhouse of the Chinese industrial machine will continue to be a key factor in the future of the country's economy. Indeed, experts have warned that the scarcity of mineral resources and energy poses an imminent threat for economic development, since it is calculated that its energy needs will duplicate by the year 2030.

The government, aware of this situation, says that for two decades the country will suffer an energy shortfall as a result of the accelerated rate of development. The State Council's Development Research Centre makes a similar prediction in a report in which it claims that the main demand will come from heavy industry, steel mills, and the construction and chemical industries, not to mention demand for private use.

Zhang Guobao, deputy minister of the National Development and Reform Commission, said in May 2005 at a high level forum on Chinese energy strategy, that the country's electricity output has already increased over three consecutive years by more than 14%. This means that the industry is not to blame for the shortage, but rather that growth in demand has risen too fast. The crisis is due to bad planning in 1999 by the Chinese government itself, which did not accurately predict the increase in energy demand that forecast growth would bring with it.

Notes

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The public authorities are responding by building power stations, many of them nuclear. Experts advise that restructuring of the industry be sped up with the influx of private capital and encouragement for the use of other sources, such as natural gas and wind power. According to the International Energy Agency, China requires investment of $2.3 trillion in energy-related projects to 2030.

Nonetheless, the most important actions in this field involve energy saving. The deputy primer minister, Zeng Peiyan, recently said that China would accelerate reform in the price of the country's main energy sources (coal, electricity and oil) with the aim of "quadrupling China's GDP to 2020, while energy consumption will rise only twofold".

In any case, the Chinese administration is taking measures to ensure the future supply of energy resources by copper-fastening its exploitation agreements in African and South American countries.

The following sections will try to diagnose the situation of the Chinese energy industry. Clearly, any analysis of China's current situation would be incomplete without an in-depth review of the perspectives for this industry. We will also analyse the ecological impact that the massive increase in energy consumption is having in China and on neighbouring countries.

Coal

Coal, which has now largely fallen from favour as an energy source in developed economies was, nonetheless, the great engine of the Industrial Revolution. Generally speaking, its is not a particularly clean energy source (indeed, it is a very pollutant one) during consumption and in the mining process, and moreover it is not renewable. Experts therefore believe that no long-term growth strategy should be based on continued use of this resource.

Chen Yao, a researcher at the Institute of Industrial Economics of the Chinese Academy of Social Sciences said in February 2005 that "increasing coal production and transport capacity is not the best way of relieving the country's energy shortage in the long term"[3].

However, it is noted that coal will continue to be China's main source of energy at least for the next ten years to come. Total coal production in the country came to over 1.9 billion tonnes in 2004, up 15% on the previous year, and it is predicted that 2005 will end with total consumption of 2.1 billion tonnes.

3. Véase See http://www.spanish.xinhuanet.com/spanish/2005-02/02/content_75775.htm

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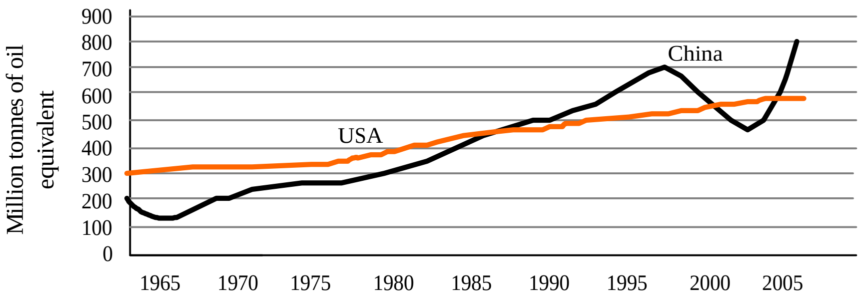
Because of this, it is very necessary to increase efficiency in the use of coal. Many Chinese thermoelectric plants are inefficient and highly pollutant, a hangover from a time when neither of these issues were listed among the economic parameters of a planned economy. Chen Yao sets out a range of measures for improving efficiency combined with strong investment in renewable energy to allow China to reduce coal consumption by 500 million tonnes over the next two decades.

Chen also proposes that the coal industry should be allowed to enter partnerships with electricity plants and steel producers to form conglomerates integrating production of coal, electricity and steel.

Coal Consumption in China and the United States.



Source: Herat Policy Institute.

■ Oil

China was the world's second largest consumer of petroleum derivatives in 2003, ahead of Japan for the first time, with total demand of 5.56 million barrels a day (bbl/d). The Energy Information Administration (EIA) estimates that Chinese demand for crude oil will come to 12.8 million bbl/d before 2025, with net imports of 9.4 million bbl/d.

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Comparative oil consumption
(in million barrels by day).

Country	Oil Consumption	Date of Information
World	77,040	2001 est.
United States	19,650	2001 est.
European Union	14,540	2001
Japan	5,290	2001 est.
China	4,956	2001 est.
Brasil	2,199	2001 est.
India	2,130	2001 est.
Spain	1,497	2001 est.
Hong Kong	0,257	2001 est.

Source: CIA, *The World Factbook 2004.*

It is estimated that oil needs will grow by 12% per year, pushed by automobile sales to over 450 million tonnes in 2020. Seventy percent of the total will be imported.

China represents 7.7% of global oil demand and its growth over the last four years is a very important factor in global oil markets. China has been a net oil importer since 1993 and, the country's oil industry therefore centres on meeting domestic demand.

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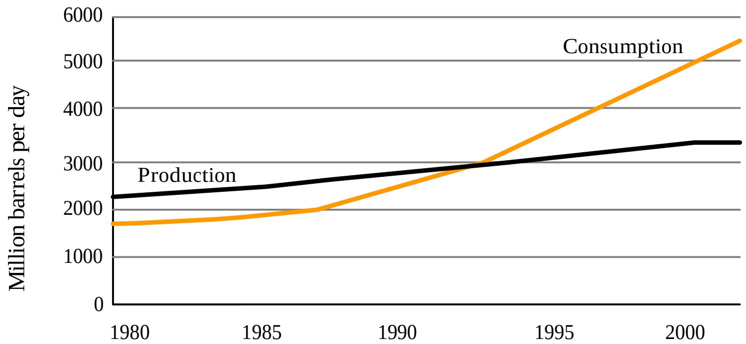
Oil production and consumption in China (1980-2003).



Source: CIA- *The World Factbook 2004.*

The Chinese oil industry has seen major changes over the last decade. In 1998, the Chinese government reorganised most of the state's oil and gas assets into two vertically integrated firms: the China National Petroleum Corporation (CNPC) and the China Petrochemical Corporation (Sinopec). Regulation of the industry now comes under the responsibility of the State Energy Administration (SEA), set up at the beginning of 2003. The Chinese government stipulated in July 2001 that only CNPC and Sinopec would be able to open new service stations before China met its commitment to open up the market in 2004. This was simply an attempt to consolidate its control over sales of retail oil products and ensure that foreign companies would have to associate with Chinese companies if they wanted to enter the retail market, even after 2004.

With expectations of an ever greater future dependency on crude oil imports, the country has been acquiring exploration and production interests overseas. Investment to date comes to six billion dollars in gas and oil companies throughout the world, according to the China People's Daily, the press organ of the Chinese Communist Party. Beijing is immersed in a process of diversification of its supply sources (traditionally the Near East), leading it to negotiate crude oil and gas contracts in Central Asia, South East Asia and Russia.

Despite these efforts to diversify supply sources, nearly half of all oil imported in China comes from the Middle East; Saudi Arabia alone accounted for 17% of total imports in 2003. Eastern Russia is seen as a potential source for Chinese imports of crude and the Russian and Chinese governments have been negotiating the possibility of building pipelines to allow such exports.

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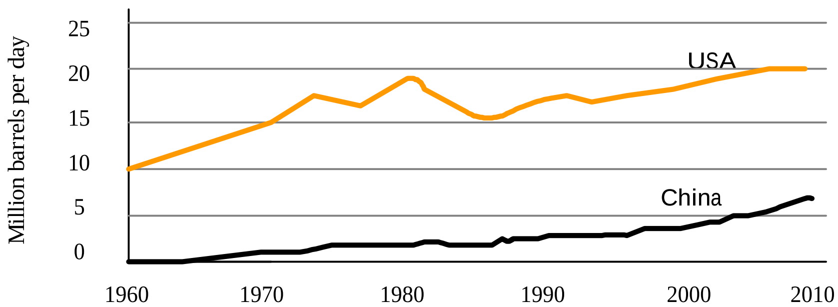
Given such an important increase in demand for oil, the possibility of building more modern refineries is being studied. China wants to create a strategic national oil reserve, a decision which was announced politically in February 2003. Since then a number options have been examined for creating such a reserve.

Oil Consumption in China and the USA.



Source: Herat Policy Institute.

Natural gas

Historically, natural gas has not been an important fuel in China. Due to the domestic reserves it possesses, however, with 53.3 million cubic feet identified at the beginning of 2004, and the environmental advantages of using natural gas, the country has begun a major expansion in its gas infrastructures.

Natural gas now represents 3% of total energy consumption, but this proportion is expected to double before 2010. This would mean an increase in domestic production and imports through pipelines and in the form of liquefied natural gas (LNG).

The country's largest natural gas reserves are located in the western and north central areas, requiring investment in pipeline infrastructure to carry it to the cities in the East, which, whose dynamic economies make them the most important centres of demand.

An important obstacle for China's gas projects is the lack of a unified regulatory system. At present, prices are set using a series of local regulations. The Chinese government is preparing the draft of a new legal framework for the industry, but the process has been slow and there are still considerable uncertainties with regard to the regulation of prices and taxes on sales of this resource.

Notes

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It is predicted that the greatest future growth in the fuel area will be in natural gas, partly because of the environmental problems suffered by the rapidly industrialised coastal provinces, although the largest increase in absolute terms will probably come from coal.

- Electricity

In the late 1990s, China suffered a problem of over-supply of electricity, due mainly to the closure of the clearly inefficient government-owned industrial units, which were large electricity consumers.

The Chinese government responded to this production surplus by closing some small thermal power stations and imposing a moratorium (with some exceptions) on approval for the building of new power stations, which came into force in January 2002.

In 2003, the Chinese government approved thirty new power projects, with a total capacity of 22 gigawatts. Alongside the economic growth of that year, power demand also rose, exceeding previous forecasts and leading to a shortage in generating capacity, with serious problems in certain areas. A lack of rainfall in some areas in 2003 and 2004 has further worsened the problem. Growth in Chinese power consumption is forecast at an average of 4.3% per year to 2025.

3.1.4.2. Environment

China suffers important energy-related environmental problems. According to a report from the World Health Organisation (WHO), seven of the world's ten most polluted cities are in China. The large-scale use of dirty coal throughout the country is causing major emissions of sulphur dioxide and suspended particles.

China is also important to any effort to reduce greenhouse gas emissions, since it is expected to have greater absolute growth in carbon dioxide emissions from here to 2020. In addition, the country is not a signatory to the United Nations base agreement on climate change, which means that it disagrees with the targets for reducing carbon dioxide emissions established in the Kyoto Protocol.

The Chinese government is increasingly aware of its environmental problems. There is a conviction that they cannot be brushed off as an undesirable by-product of economic prosperity, since they may affect the future development of the economy itself. In 1998, after savage deforestation of the banks of the Yangtze River caused flooding on such a scale that it cost the lives of 2,500 people and hundreds of millions of dollars to state coffers, the Chinese government took measures against tree-felling.

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Laws were passed to protect forests considered to be healthy, and rehabilitation of devastated forest areas was ordered, along with reforestation of unproductive agricultural areas.

In 1999, the then deputy primer minister, Wen Jiabao, warned that the very "survival of the Chinese nation" was threatened by water shortages. The country has large tracts of desert or very arid land and water has always been a problem. Decades of pollution and the exhaustion of aquifers has worsened the situation to such an extent that over a hundred large cities today suffer from a shortage of drinking water[4]. Indeed, the World Bank calculates that there is only just over 2,000 cubic metres of fresh water per person in China, when in Spain — generally considered to be a very dry country— this figure is 2,700 cubic metres.

For all of these reasons, China has announced that it "will work to attract more foreign investment boosting its recycling economy and helping develop new pollution-free energy sources"[5], in the words of a senior official on environmental protection. This is a target which China will meet without renouncing its current growth or, rather, conscious of the important role played by the environmental industry and recycling in maintaining a high growth rate.

The forecast is for the environmental protection industry in China to generate revenue of around $36 billion in 2005, and according to Chinese leaders, it will top $60 billion by 2010. This industry may hold out worthwhile opportunities for foreign companies interested in investing in China. It is predicted that coal will continue to be the main fuel source in the country for at least another decade, and the government is therefore willing to invest heavily in developing alternative energy sources in the medium term.

Furthermore, substantial measures —including pricing policies, taxes and tax incentives— are going to be taken to make better use of private capital and facilitate the use of new energy, in order to tempt foreign capital to invest.

Clearly, China's ecological imbalances are many and very serious, and are already affecting other countries in the region. To give just one example, while it is true that the government has placed severe restrictions on the indiscriminate felling of trees, high demand for timber for building is causing deforestation of the tropical forests of Thailand and Malaysia. Nonetheless, China has the advantage of being able to count on the experience of other already industrialised countries, whose economic development caused (and continues to cause) serious environmental damage. The country has the opportunity to be proactive, incorporating environmental protection policies into the process of economic development-something which Europe and United States in their time were unable to do.

4. The Economist, "Drying up", May 21st 2005, p. 62.

5. See http://spanish.people.com.cn/31620/3401578.html

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The problems are serious, but, if the Chinese government is firm in its determination, the Asian giant may prove to be a model of ecologically sustainable industrial development.

3.2. Tackling the Myths: Today's China

The goal of this second section is to sort through the information in the previous section and elaborate on certain areas. Having looked at some key figures for the country, with its overwhelming socio-demographic data, its spectacular economic growth and its energy limitations, we now want to study China's present situation in greater depth, by tackling some of the preconceptions that tend to arise whenever this country is mentioned. The aggregate figures may serve as a yardstick for measuring China against other national economies, but they tend to hide much more complex and diverse realities. While recognising that it would be impossible to make a complete study of all of China's many different facets in a publication of the size and objectives of this one, we would like to advance a little further and examine the points raised in the first section in greater depth.

Demographically speaking, a fifth of the world's population is Chinese. In itself, however, this figure is misleading: there are 1.3 billion people who share a nationality, but that does not mean that they share much else. Indeed, China is a fully-fledged continent, if not geographically, at least in terms of its ethnic, cultural and demographic variety. As we shall see, China's population embraces 55 ethnic groups, 450 languages and as many different cultures.

Can we then speak of the People's Republic of China as a monolithic entity, as people have done until now? Do the macroeconomic data faithfully describe its multifaceted reality?

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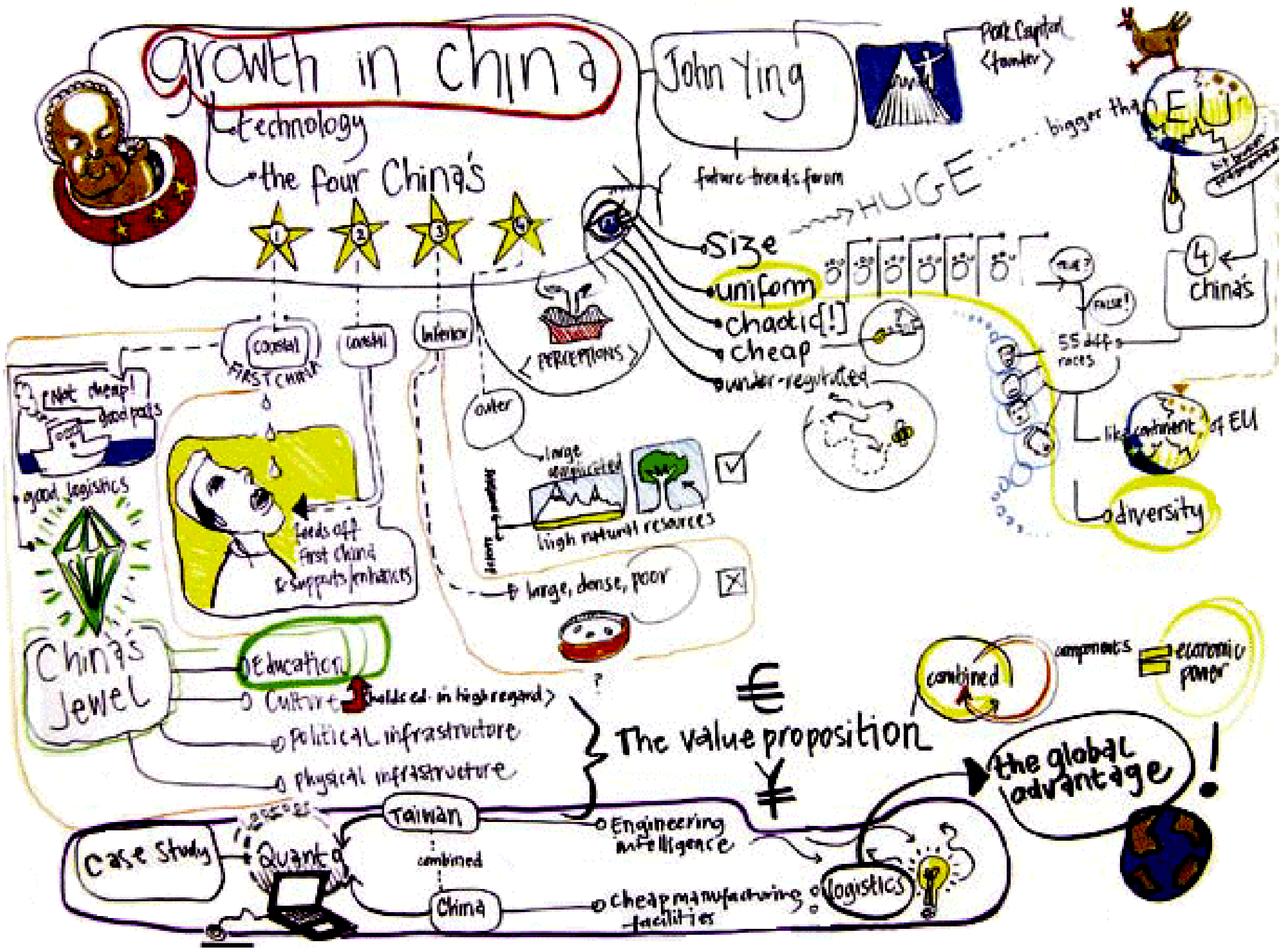
The Four Chinas.



Source: Fourth FTF Meeting.

3.2.1. The Four Chinas

China is divided into thirty-one provinces, special administrative regions and municipalities, of differing size and population. Although any generalisation tends to distort the real situation to some extent or another, in that it ignores cases that fall outside the norm, experts agree in grouping these provinces into four very different spatial entities: Outer China, Inner China, Coastal China and "First" China. Each of these could represent a different nation due to the massive demographic, geographical, cultural and socio-economic differences they display.

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The Four Chinas.

Outer China

Outer China gets its name from its position with regard to the rest of the country, not in relation to the rest of Asia. It includes the provinces of Inner Mongolia, Ningxia, Gansu, Xinjiang, Qinghai, Tibet, Yunnan, Guizhou and Guangxi. It is distinguished by its topography: the Tibetan plateau and the Gobi desert are its best-known geographical features. It has great development potential for an economy based on natural resources, although the problem of its difficult accessibility would have to be overcome: the average altitude in the valleys is between 3,000 and 4,000 metres (10,000 - 13,000 ft) above sea level. In terms of size, the region is eleven times as big as Spain. However, it is the least populated of the four Chinas: only 215 million inhabitants, with a relatively low population density (36 per sq. km.).

Notes

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- Inner China

Inner China consists of the provinces of Shanxi, Sichuan, Hunan, Jiangxi, Anhui, Henan and Hubei. It has twice the population of Outer China, but because it has a much smaller land area (approximately three times the area of Spain), the population density is greater. This area is very poor and lacks the natural resources of Outer China. Its economy is based on agriculture. Although in the very long term it has great potential for development, it would first be necessary to invest in education and the physical infrastructure.

- Coastal China

Coastal China encompasses the provinces of Heilongjiang, Jilin, Liaoning, Tianjing, Hebei, Shaanxi, Shandon, Jiangsu, Zhejiang, Fujian, Guangdong and the island of Hainan. It benefits from the irradiation of wealth, education and culture from the First China. It also has the advantage of having direct access to the sea. However, its 429 million inhabitants, a third of the country's total population, account for only 25% of national GDP. In the medium term, it has great potential for development.

- The First China

The First China includes only the municipalities of Beijing, Shanghai and Hong Kong, their metropolitan areas and their immediate areas of influence. It is the focus for investment, the most visible face of China and the one on which much of this document centres. Though it covers only 3% of the national territory, it is still equivalent to somewhat over half the land area of Spain. It is home to 154 million people, the same as all of Russia, but nonetheless accounts for only 12% of the Chinese population. GDP per capita here is higher, at $4,000 dollars, putting the First China far above the national average, at a level comparable to that of some European countries.

These three cities form a powerful combination. Shanghai has set itself the target of raising local per capita income to $10,000 in a few years' time. If the entire region managed to attain these average income levels, with the addition of Taiwan, its economy would be somewhat larger than Germany's. In short, China's dense population is a potential asset for the whole territory, the growth that has so surprised the rest of the world can only be achieved in combination with other ingredients that occur solely in the First China.

3.2.1.1. "One Country, Two Systems"

The two former European colonies, Hong Kong and Macau, have been integrated under the Chinese Communist Party's "one country, two systems" policy. The concept is based on maintaining a single political system under the umbrella of the Beijing government, while allowing separate and distinct financial systems to coexist. Hong Kong and Macau both have their own regulatory bodies and their own currency.

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Both cities are special administrative regions released from the British and Portuguese metropolises in 1997 and 1999 respectively. In certain administrative areas (the judicial system, customs and borders) they are also independent, although controversies and confrontations sometimes arise with Beijing.

Hong Kong is one of the great financial centres of Asia. Its economic freedom attracts investors from across the globe. Most local families do not invest in Hong Kong, but in Southern China or in Shanghai, making this city the main source of direct Asian investment in China.

For its part, Macau's economy is not based on the financial industry but on its position as a tourist and gambling conglomerate. As well as enjoying the status as a tariff-free zone, it receives many visitors to its casinos, which are banned both in Hong Kong and in mainland China. The gambling industry has also triggered a proliferation in illegal activities, such as prostitution.

3.2.1.2. The Taiwanese case

Although considered by the People's Republic of China to be just another of the country's provinces, Taiwan merits a separate section, given its historical and economic peculiarities.

The history of the island of Formosa makes it rather special since Chiang Kai-Shek and the Kuomintang nationalists took refuge here after they were driven off the mainland in the civil war. The Chinese Communist Party has always stuck to its intention to govern the island like any other region and has kept up the threat of intervention should the island make any moves towards secession. However, the nationalist refugees have received support from the United States as a strategic ally since 1950. This has helped the island prosper economically, while at the same time keeping it off the CCP's radar of influence. Indeed, Taiwan has been diplomatically recognised as an independent republic for many years.

The People's Republic of China began to flourish in the 1970s and the United States opened trading and diplomatic relations with the country, closing its embassy in Taipei, since Taiwan did not look favourably on any country that recognised the Beijing government. In the 1980s, the Taiwanese economy continued to grow and it underwent a transition to democracy. In the 1990s, the two Chinas began talks on reunification. Taiwan demands the introduction of a democratic system in the People's Republic of China, while Beijing has held on to the idea of "one country, two systems", as with Hong Kong. Economic relations between Taiwan and the mainland, however, are prosperous and fruitful. The island of Formosa has 23 million inhabitants, of whom more than a million work in China. In addition, Taiwanese capital investment in mainland China comes to around $125bn.

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3.2.1.3. Reasons for the differences between the four Chinas

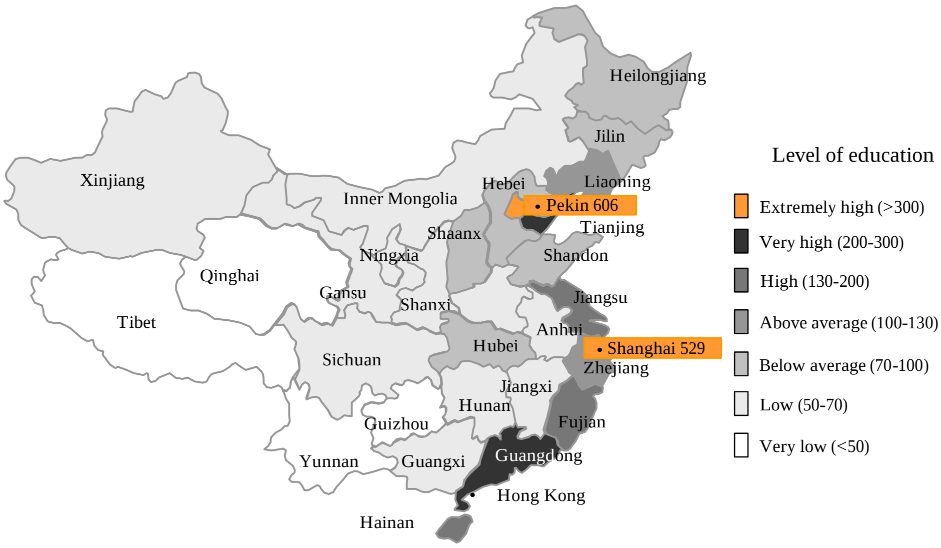
As well as geographic factors, there are other reasons that explain the vast differences exist between the country's various regions. The origins of the First China's predominant position are historical. This is the area in which the cultural elites have always lived and for centuries it has wielded political hegemony, as the centre of the mechanisms of political control. It is also the place in which the government invests money and tends most to, generating a physical infrastructure and an industry that attracts migrants from rural areas, eager to work in the new industry. Finally, the quality of education in this area is also much higher than in the rest of China.

This classification of China into four differentiated socio-economic regions is therefore based on culture, politics, infrastructure and education. Let us now turn our attention to the last of these aspects, the massive internal differences in educational levels in China.

■ Education

The huge disparity in educational levels among the inhabitants of the four regions explains, to a large extent, their varying economic strength. A study carried out by the University of Tsinghua in 2001-2002, published by the World Bank, demonstrates the extent of the gulf between them. Table 23 has been prepared using this study, and assigning a value of 100 to the average educational level for all of China.

Level of education by provinces.



Source: University of Tsinghua for the World Bank.

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This distribution in education reflects the concentration of intellectual talent in the First China. Practically all of the over 300,000 engineers who graduate every year in China are concentrated in the areas of Beijing, Shanghai and Hong Kong, where 154 million people live. In addition the cost of skilled labour is low in comparison with that of OECD Countries, although higher than in the rest of China.

The challenge posed by the educational gap is overwhelming. China has 218 million children in primary education, more than the entire population of Japan and South Korea put together. There are over ten million teachers and more than 500,000 schools, 75% of which are scattered across the territory, far from the urban nuclei of the coast. However, the Chinese intellectual elite fears that this will not be enough to make up for the huge differences in educational infrastructures in poorer regions. In Pucheng, for example, a village located in the mid-north of Shaanxi, the students share desks in waterlogged classrooms with no electricity. There are also far more boys than girls, since many of the peasants refuse to send their daughters to school.

3.2.2. The political system

Every foreign investor in China asks the same question: can China continue to advance its economic development and the liberalisation of its economy with the existing authoritarian political system?

In 1978, Deng Xiaoping began a progressive political and economic liberalisation. The political part of this change came to a brutal end in 1989, with the events of Tiananmen Square. Since then, the Chinese political system has gradually been weakened as a result of staggering economic development, decentralisation and corruption, although it maintains all its iron-fisted powers of repression.

Political power is wielded by the Chinese Communist Party (CCP). It has 66.4 million members (5.2% of the population) of whom 17.5% are women and only 52% have completed their primary education. The CCP holds legislative and executive powers. Its executive organ is the Central Committee, which has 356 members (198 permanent and 158 alternating) and meets twice a year. In its absence, decisions are taken by the Politburo, which has 24 members and which in turn, delegates the most important decisions to the Politburo Standing Committee, formed by nine of its members. On the legislative side, the 2,989 delegates of the National People's Congress (NPC) elect the members of the Central Committee, the Politburo and the Politburo Standing Committee for periods of five years.

In reality, Hu Jintao is the general secretary of the CCP, chairman of the Politburo and the maximum representative of the Politburo Standing Committee. He is also deputy chairman of the Central Military Committee, the maximum organ in control of the China People's Liberation Army.

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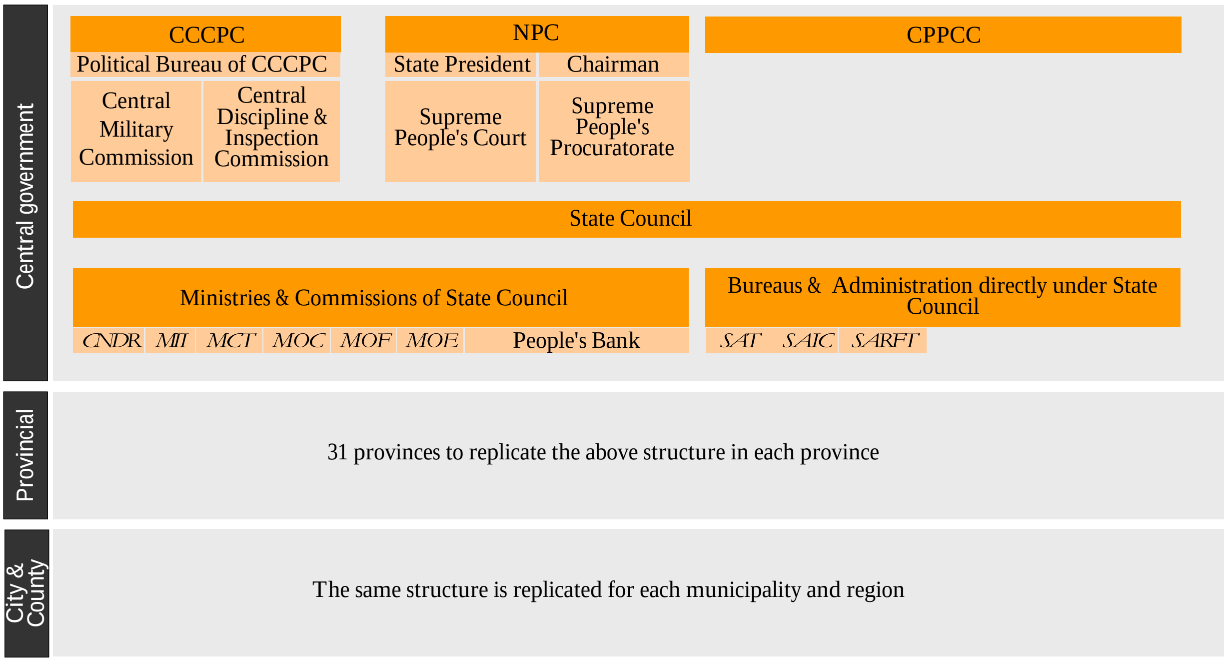
Organisation of the Chinese political system.



NDRC: National Development and Reform Commission
MII: Ministry for the Information Industry
MOST: Ministry of Science and Technology
MOC: Ministry of Communications
MOF: Ministry of Finance
MOE: Ministry of Education
SAIC: State Administration for Industry and Commerce
SAT: State Administration of Taxes
SARFT: State Administration of Radio, Film and Television

The CCP maintains a monolithic power structure. There are bodies representing interest groups such as women, farmers, workers, etc. but they all serve the CCP. Even before the CCP mobilised against the student revolt of Tiananmen Square in 1989, the amalgam of trade unions that emerged during the protests had been declared "counter-revolutionary". In this way, the CCP ensures that any pressure group outside the power base will be under-represented.

The CCP also carries out doctrinal work through its "work units". Traditionally, Chinese state companies provide their workers not only with wages, but also accommodation and education. And the "neighbourhood committees", also under the control of the CCP, offer indoctrination in areas such as family planning and crime prevention.

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Nonetheless, this strict control has been easing in recent years for a number of reasons: on the one hand, labour reforms have caused a gradual move of civil servants towards the private sector; on the other, twenty years of uninterrupted growth have led to greater social mobility and a certain business mentality. Of all of these factors, however, the social discontent which has so seriously eroded the prestige of the Chinese political system has been mostly caused by two different factors: corruption and the decentralisation of power.

The endemic corruption suffered by the CCP since 1978 appears impossible to stem. Reiterated calls to members to abstain from becoming involved in private businesses do not appear to have borne fruit, although the CCP announced the dismissal of 124,000 party members between 1997-2002 and even the execution of some of its officials, convicted of corruption. The introduction of measures intended to eliminate corruption has not been entirely effective either[6].

As for decentralisation, the CCP has taken very categorical action against the slightest hint of secessionism but the topography and demographics of China mean that a large proportion of the decisions need to be transferred to the local organs of power of the 31 provinces and the thousands of municipalities—some Chinese provinces are larger in land area and population than the major countries of Western Europe.

The provinces and municipalities, for their part, are capitalising on the increase in resources and their impunity to intervene in local business and businesses despite the dictates of central government.

The CCP has always reacted uncompromisingly to maintain the existing political framework. Dissidence and public questioning of the system are quite simply not tolerated. The party accepts a certain degree of grumbling among civil servants about reforms in public companies, but any organised protest is savagely quelled. Access to the Internet and the national media is censored. Against this backdrop, it seems reasonable to wonder whether China will evolve towards a democratic system over coming years.

3.2.3. Putting the Chinese economic boom in context

When people speak of the growth of China, they normally do so in tones of praise, while at the same time trying to predict the country's capacity to keep up the same rate of expansion in the future. Underlying this is a perception that the development of the Chinese economy over recent years has been extraordinary, but has it really?

6. See the section on corruption below..

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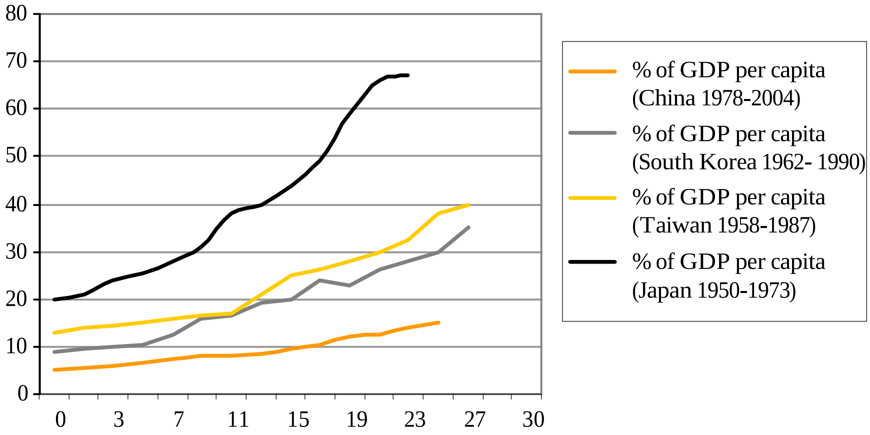
In order to say whether the "miracle" is real or not, we need to compare the Chinese model with other historical examples of growth. Since 1978 China can be seen to have grown at an average rate of 6.1%, representing an increase in GDP per capita of 370% over the period. Certainly, this is a spectacular rate of growth, but to put these figures into perspective, we need to compare them with those of other Asian economies. Japan, for example, Japan grew at an average rate of 8.3% between 1950 and 1973, giving an increase in GDP per capita of 460%; Taiwan saw an annual growth rate of 7.1% between 1958 and 1987, giving a total of 600%; and South Korea grew at 8.2% between 1962 and 1990, to give an increase in GDP per capita of 680% for the period.

Economic growth in SE Asia.



Source: Financial Times.

Viewed in these terms, one might even legitimately ask why China has grown so slowly. Naturally, China is a country of superlatives, much larger and more complex than any of the other countries mentioned and what there is not directly applicable to the Chinese case. However, experts argue that, precisely because it is much larger and also because it started from a position behind that of the other three economies, it should have grown more. They add that the speed of an economy's growth depends on how much it lags behind the productivity levels of the most advanced economies. When China first began to grow, after Deng Xiaoping's 1978 reforms, its GDP per capita was a twentieth of the United States', whereas Japan's, in 1950, was only a fifth of the American figure.

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China possesses the same ingredients as these three other Asian economies: cheap labour, willing to continue working hard, the ability to transfer workers from the low-productivity agricultural industry to the industrial sector, political stability and a government will for development. In addition there is its extraordinary investment capacity, with a fixed investment rate of around 40% of GDP.

Why, then, has China not been capable of equalling or outstripping Japan, Taiwan and South Korea? The answer may in part lie with the huge inefficiency which the Chinese economy continues to drag behind it. State companies represent a brake to growth, while the impracticable financial system suffers from a very high ratio of bad debts (%) —40% according to the rating's agency Standard & Poor's[7]. This figure is significant, since it gives a measure of the effectiveness of investment: such a high rate of unreturned loans suggests that the use of capital resources has been disastrous. Japan, Taiwan and South Korea, with comparatively much lower investment rates, obtained better returns on the money invested.

From this point of view and whatever the ultimate causes of its relatively small success, it is clear that China's development over recent decades could have been much greater. Moreover, the evidence from its neighbours suggests that the country still has a lot of potential for further growth. So should Europe and the United States be afraid of the foreseeable growth in the Chinese economy over coming years?

It is true that there are industries which are very directly affected by Chinese exports and typically, textiles, footwear and of other manufactures are always mentioned in this context. Generally speaking, however, commentators ignore the fact that if Western consumers buy Chinese imports, it is because they provide them with a benefit.

According to Morgan Stanley, low-cost Chinese imports into the United States (in addition to textiles and footwear he also mentions toys and home products) have represented a saving of 100 billion dollars since 1978 for American households. He stresses, moreover, that the main beneficiaries have been low or medium income families. He cites the example of Chinese baby clothes which helped families with children to save $400m between 1998 and 2003. Similarly, American giants such as Boeing, Ford, General Motors, IBM, Intel and Motorola also save millions of dollars every year by buying low-cost components in countries like China, thus increasing their capacity to compete globally, a factor which undoubtedly favours the US economy as a whole.

There is also a tendency to forget that China has become a potential market of 1.3 billion consumers, eager for quality imported products. It is estimated that there is currently a market of 100 million people considered to be higher or higher-middle class[8], i.e., with a per capita income of over $7,000 a year.

Notes

7. Fuentes oficiales chinas, como se menciona más adelante, cifran esta tasa en el 25%, que, en cualquier caso, sigue siendo muy elevada.

8. Robert Wang: "China's Economic Growth: Source of Disorder?", *Foreign Service Journal*, May 2005.

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This figure is increasing at a dramatic rate, turning the country into a market with ever greater purchasing power. To return to the American case, the US Trade Department says that exports to China have grown by 80% since 2002 and that China is now the fifth largest market for American products.

Summing up, growth in the Chinese economy has not been as exceptional as it might appear if we were to disregard the recent history of other economies in the region. It could and should have been even faster. It is true, though, that the increase in demand for raw materials to feed this growth has placed huge pressure on global prices and that some industries have been seriously harmed by the appearance of cheaper Chinese products.

However, it is no less true that the benefits of Chinese growth for the world economy have been and will continue to be very considerable.

3.2.3.1. First indications of economic slow-down

Many specialists argue that China's transformation into a market economy has already taken place and that the Chinese economy is therefore beginning to be governed by the same economic principles that operate in other Western economies. This would mean that the Chinese economy would be expected to suffer the same Schumpeterian cycles seen in other deregulated economies, in which, generally speaking, an upturn is followed by economic recession, in generic cycles of 8 to 10 years.

According to the experts, four factors have been decisive in China's becoming a free market economy:

- The liberalisation of most prices for goods and services (many are still controlled by the central government, but this is also the case in very many deregulated economies).

- The recognition of private property in the Chinese constitution of 1999 and its progressive introduction into the market.

- The introduction by the central government of policies of transparency and incentives to investment as a result of China's membership of the WTO.

- The restructuring of the capital market with the formation of new private banks and different forms of investment, from corporate bonds to risk capital.

If this is true, then the first alarm bells of an economic slowdown are already being heard. Some macroeconomic —and particularly microeconomic— indicators related to corporate profits and average payment times show the first signs of weakness.

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Macro and Microeconomic Indicators.

VARIABLE	DANGER SIGN	CURRENT SITUATION	FEBRUARY 04: SIGNS OF DECELERATION	MAY 05: SIGNS OF DECELERATION
Macro				
Fast monetary growth.	The pace of year-on-year growth is far above the 10-year average.	The M1 is below the average for the last 10 years, as is the M2.	No	No
Rapid credit expansion, as compared to the trend.	Deviation from the trend is one time the standard deviation, although the current heating-up is about 2 or 3 times the standard deviation.	On trend	Yes, but not yet to a radical degree.	No
The balance of payments plus net flows of DFI.	The deficit is over 3% of GDP.	Surplus equals 5% of estimated GDP for 2004. CLSA estimates a surplus of 3.9% for 2005.	No	No
In general, acceleration in inflation.	CPI increases of over 5% per year.	Year-on-year CPI growth in March: 2.7%. Although compared to last year, the basic inflation rate is increasing.	No	No
Share prices rise, and the pressure affects the most hazardous ones.	Shift from properties and bonds to shares. Two-figure increases in property prices.	In general, inflation in the property market has reached two figures. Asian stock markets saw the worst results in 2004.	No	Yes, but concentrated particularly in the property market. Increase in casinos.

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VARIABLE	DANGER SIGN	CURRENT SITUATION	FEBRUARY 04: SIGNS OF DECELERATION	MAY 05: SIGNS OF DECELERATION
Costs rise, especially labour	Salaries rise faster than sales or nominal GDP. The costs of raw material is spiralling.	Statistics for official income underestimate the increase.	No	Yes
Micro				
Corporate profits	In general, profits are down on the previous period (quarterly and cycle adjustments included).	The share of quarter-on-quarter aggregate net profit fell by 38%. Year-on-year growth is slowing down.	No	Yes, but still growing apace with nominal GDP.
Amounts to be received/debtors	Inexplicably, these are generally increasing.	Two-figure increases below growth in nominal GDP. Not explosive as yet.	No	No

Fuente: *CLSA: Asian Economics Research.*

Two structural problems suffered by China need to be mentioned here, typical as they are of the first economic cycle of a new capitalist economy: scarcity of skilled labour and underdevelopment of the financial system.

3.2.3.2. Scarcity of skilled labour

The most widely held preconception about China is that it has an abundance of labour. However, the scarcity of qualified staff, particularly in the middle management segment, is generating a major bottleneck in setting up new commercial establishments and private companies. This shortfall is having two immediate effects: on the one hand, an increase in labour costs and a reduction in corporate profits without a parallel gain in productivity, generating inevitable inflationary tension; and on the other, an important move by public-sector employees to private industries with more appealing salaries, leading to a clear deterioration in the quality of public services, increasing comparative grievances and an irremediable increase in corruption.

The middle segment of qualified personnel is probably the least valued in the production chain; however, without them production lines become disorganised, qua-

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lity slips and productivity falls. As skills intensify, the need to increase productivity and labour efficiency grows and the demand for qualified managers intensifies.

Until now, China has been importing hundreds of thousands of managers from abroad, principally from Taiwan, since the Taiwanese have the additional benefit of speaking Mandarin Chinese fluently. It is estimated that between 800,000 and 1,000,000 Taiwanese live in mainland China, representing 4.4% of the Taiwanese population and 9.7% of its workforce. The result is that this reserve of skilled labour has been practically exhausted and a manager is paid the same in mainland China as in Taipei, despite differences in the cost of living.

Analysts estimate that the cost of qualified labour will rise by 20% per year over coming years, clearly outstripping the sustained growth in Chinese GDP and annual inflation.

3.2.3.3. Underdevelopment of the financial system

The Chinese financial system continues to restrict foreign investment and the four large public banks still control 70% of Chinese credit activity. Generally speaking, Chinese banks have always been closely controlled by the central government, which decides when it should stay its hand, offer easy credits to generally uncreditworthy individuals and corporations and when it should make conditions tougher. The result is that in the period from 1996 to 1999 non-performing loans accounted for 25% of the total (this is the official rate; unofficial sources place the figure at closer to 50%), whereas the internal credit rate continued to grow at annual rates of between 14% and 24%.

One is easily reminded of the effects the collapse in financial systems had in neighbouring countries. Credit in Asian countries shrank rapidly after the crisis of 1997-1998, whereas in Japan, with similar bad debt figures to the Chinese ones, credit has been contracting for over a decade. In the United States, when the rate reached 5%, the credit system was frozen. However, nothing of the sort has happened in China, where the market continues to borrow as if every loan were guaranteed.

Notes

In the context of current growth patterns, financing is shifting towards the private sector. Although there are no official figures on distribution by sectors, it is estimated that personal loans (including mortgages) now represent 15%, meaning that private sector financing must necessarily play a very significant role. This should set even more alarm bells ringing, since public sector borrowing in China is, by its very nature, considered to be guaranteed.

A foretaste of the damage that credit shrinkage would cause to Chinese economic growth could be seen in 2004, when, after a sudden toughening of loan provisions to five industrial sectors, the government was forced to lower its growth forecasts by up to 7%. Apart from this one occasion, central government has never taken measures and has always trusted that the credit position would improve naturally by 2007, either through a growth in assets or through recapitalisation of the worst banks

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before the market opens to competition.
A cooling of the Chinese economy would inevitably lead to stricter credit conditions. Since any cooling may be expected to bite into the profits of a large number of corporations and extend collection periods on current accounts, many companies might face serious difficulties in finding the transitory refinancing they need to see out the crisis.

It is reasonable to expect that both the labour shortage (and the consequent rise in labour costs) and the weakness of the Chinese financial system will create inflationist stresses, which will force the government to toughen its monetary policy and raise interest rates, with very serious consequences for China's growth potential in coming years.

3.2.4. Corruption

There is a common impression in the West that Chinese bureaucracy-so inescapable when doing business in the country-is fundamentally corrupt. The administration itself has acknowledged some serious cases of corruption among civil servants, which have generally received extensive media coverage in China itself and sometimes also in Europe and the United States.

Corruption is a fact. The Chinese government is aware of the damage its causes to its reputation and has launched, albeit unevenly and sporadically, major campaigns to fight it.

This section describes both the problem and the measures being taken to resolve it and assesses the effectiveness of these measures in the light of the results to date.

3.2.4.1. Corruption in figures

The People's Republic of China has the largest number of civil servants behind bars of any country. Although this figure in itself would have only a relative significance (it is also the country with most civil servants), there is a feeling that corruption among public sector employees is considerably higher than in OECD countries. Over the last five years, the government has recognised more than 200,000 cases of misappropriation and bribery, a rate of 113 cases a day. This is a high figure even for a country of the size of China.

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The European press tends to give ample coverage to corruption cases among senior officials leading to execution. Recently Cheng Kejie, the former vice-chairman of the National People's Congress (the Chinese equivalent of the legislative chamber) was executed for accepting nearly five million dollars in bribes. The case was headlined around the world.

The problem is serious even from an economic point of view. The central government recently cited the recovery of 2,660 million dollars since 2002 for the treasury office as a major achievement for its judicial system. However, no estimate was given of the percentage this figure represented of the total amount stolen.

Increase in Corruption.

Annual increase in the number of cases investigated and heard by the fiscal and disciplinary inspection authority's bodies throughout the country since 1993.	9%
Cases of misappropriation, bribes and other related cases over the last 5 years.	207.103
Annual increase in the number of civil servants on whom the party and the government have imposed disciplinary sanctions.	12%
Annual increase in the number of civil servants on whom the party and the government have imposed disciplinary sanctions.	12%
Civil servants against whom the party and government have taken disciplinary measures due to corruption over the last decade:	
- At prefecture (department) level or higher.	Over 30.000
- At provincial (ministerial) level.	90
Number of arrests of corrupt officials who had fled justice since 2000	5115
Value of the money evaded by corrupt officials which has been recovered since 2002.	22 billion Yuan ($2.6bn)

Source: Figures taken from the report of the Supreme People's Procuratorate presented to the annual session of the Tenth National People's Assembly.

3.2.4.2. Measures intended to prevent corruption

The Chinese Communist Party has woken up to the seriousness of the issue, launching a number of campaigns to try to put and end to corruption. The leadership denies that the root of the problem lies, as is often claimed in the West, in the lack of democracy, pointing to examples of corruption cases in democratic countries such as Thailand, Indonesia and South Korea. Strict party discipline and a social policy based on the purest form of communism, is seen as the best way of fighting a disease which threatens to become endemic. The CCP wants to eradicate the problem at source, by paying more attention to the areas that are most liable to come into contact with money.

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Consequently, surveys, policies and initiatives to reduce corruption are now being carried out.

- Anticorruption campaign

During the 1990s, the government called on official institutions (armed forces, police, prosecutor's offices, etc.) to find their own sources of financing. State institutions became nothing short of business centres. Military officials, benefiting from a tax exemption and protected by the army's importance in China's ruling apparatus, created companies that competed at a clear advantage over other private business initiatives. The navy, for example, went so far as to use its own ships for trading, thus avoiding customs duties and threatening private dealers with bankruptcy.

In 1998, faced with the imminent collapse of the economy, the maximum authorities launched an anticorruption campaign. They demanded collaboration from the army, the police and other government institutions in establishing the best conditions for private initiative. In the judicial system, the administrative and judicial functions were unbundled, turning them into independent professions to ensure transparency.

Today there are numerous collaboration agreements, associations and even, accounting firms which run basically commercial companies selling civil liability insurance. As well as benefiting the fight against corruption, these professionalisation processes have made a major contribution to the economic development of recent years.

- Less bureaucracy

a) Reduction in the Size of Government

In 1998, the prime minister decided to reduce the size of both central and local government. Over a period of three years he eliminated practically all the ministries with responsibilities for the industrial sector (machinery, electronics, etc.) and transferred some of their functions to other government departments

b) Reform of Administrative Approval

In 2000, in cooperation with the Anti-Corruption Agency, another set of government reforms was launched, to implement what was called "Reform of Administrative Approval". Over the last five years, central and local government has halved the number of requirements needed to create a company. In many areas, for example, there are special grants for foreign investors in China, and it is now possible to fill out applications and manage the process in the local office itself. Previously, the orders used to go from the government to one office, then another, then another... and so on.

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The new systems means greater transparency, a critical factor in the fight against corruption. This practice, which began in the First China and Coastal China, is now extending inland.

c) Development: from the coupon system to a market economy

Twenty years ago, if someone wanted to buy a bicycle or a television they would not use money, but coupons. Today there is a buyers market in China for nearly all types of goods, removing considerable bureaucratic intermediation and thereby bypassing corrupt mediators. Even in the internal area, the way in which government offices buy and sell material has also changed.

d) Elimination of the stock market fee

Previously, anyone wanting to trade on the Beijing stock market had to pay a fee, which was not easy to achieve. These fees were distributed among the different ministries, the women's federation, the trade unions, the communist league, etc. which, even without being organised in the form of companies, all had their fee.

These fees have now been done away with and replaced by a process of neutral registering, in keeping with practise on the Singapore and Hong Kong stock markets.

- Greater transparency

a) Anti-Corruption Agencies

One of the powers of the National Audit Office is to regularly audit government departments, large companies and civil servants who change position, leave or are promoted. The result is that the NAO holds a wide range of powers. Indeed, last year the Auditor General was declared one of the most important economic figures in China. Other anti-corruption agencies, including the CDIC and the Ministry of Supervision, have also been reinforced and conduct regular inspections in the provinces.

b) Elimination of anonymous bank accounts

There was a time when China encouraged a policy of anonymous bank accounts. Anyone could open an account without giving their name or even producing their identity card. This policy was done away with, real names were reintroduced and government officials holding well-stocked anonymous bank accounts can now be arrested and jailed for up to five years.

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c) Creation of the "anti-corruption account"

Government officials who have received bribes still have a chance to redeem themselves. Since 2000, some Chinese cities, including Ningbo and Wenzhou (in the province of Zhejiang), Jinzhou (in the province of Liaoning) and Jinan (in the province of Shandon), have opened "Account 581"-also known as the "anti-corruption account"-into which civil servants can anonymously deposit sums of money equivalent to the bribes they have accepted (which may have come in the form of cash, gifts or shares) within a stipulated time. In turn they receive a set of receipts which will grant them a certain degree of immunity: if they are ever investigated for the crime in the future, they will receive the same treatment as officials who turned down the bribes.

By April 2001, the Wenzhou "Account 581" had received deposits of over 400,000 Yuan. At the end of May, however, the figure shot up to 1,100,000 Yuan, after the local government set a deadline on deposits.

d) Collection of fines

One very interesting phenomenon which played an important role in fighting corruption, is the implementation of the "more transparency" maxim at all levels. Some years ago, for example, the Beijing police were responsible for directly collecting fines for traffic offences, with the result that there was no trace of where the money collected went. Today, the fine has to be paid into a specified bank and an account established for this purpose, which is controlled by the Ministry of Finance.

Other reforms

a) Tax Reforms

Notes

The World Bank has worked with the Chinese government on its tax reforms. The department in charge of distributing wages to employees used to perform the operation in person in the middle of the month. In many provinces where this system was used, such as Shanxi, more than 5,000 "employees" appeared on phantom payrolls. These were people who were not actually working, but who received a wage or alternatively someone else received a wage for them. Today the wages are deposited directly into a bank account at the end of the month. This has also been helped by the creation of electronic databases.

b) Reforms in land allocation

The allocation of land by the government used to be the source of half of all corruption cases, given the large sums of money involved. In recent years, however, land is being auctioned, promoting fair competition.

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Municipal governments have realised that they can get much more money by auctioning their land to supplement government profits.
Nonetheless, there are still many loopholes to be filled. For example, as an alternative to the auction, a builder interested in the land can buy the factory located on the plot or the company auctioning the land9.

c) Standardisation of the Customs Authority

Ten years ago, the Customs Authority was one of the most independent bodies. When Julong Yi became deputy primer minister, he set about toppling the mafias in the authority and today half of its top officials are serving prison sentences.

3.2.4.3. Percolation of anti-corruption measures in society

On the international stage, China has demonstrated its good intentions by signing the UN Convention against Corruption. It is also doing everything possible to extradite officials who have fled abroad (although some countries are opposed to extradition on humanitarian grounds). However, international figures for transparency show that China continues to be one of the most corrupt countries in the world.

At local level, the land auction system has been so well received that it has begun to be used in private cases as well. Officials are now practically obliged to authorise an auction, since it would be seen as politically incorrect to return to the old system. This new attitude is also favouring foreign investors.

According to a survey carried out by Horizon Service, an independent Chinese surveying service, between 1995 and 1997 corruption was the third greatest concern among the general public. It climbed to second position in the list in 1998 and first in 1999, just when Chinese leaders decided to reinforce anti-corruption measures. In 2000, it fell to fifth position in the list of concerns and in 2001 to seventh. In 2004, it didn't even feature among the top seven. The change has been substantial throughout the last decade.

The Chinese government continues to be quite opaque when it comes to publishing data and providing sources10. Nonetheless, according to the national campaign for monitoring compliance with the laws, 24,169 cases of corruption were investigated in 1999 and "economic losses of 13,760 million Yuan were recovered or prevented". Experts say that there is still a long road to be covered, but considerable efforts are being made (see the section on "Cultural and linguistic barriers" for further practical information on corruption).

9. Véase el artículo "The Turtles", de la revista The New Yorker, julio 11-18, 2005.

10. De hecho, las fuentes oficiales chinas no ofrecen datos estadísticos sobre la corrupción.

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