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VISIT TO LONDON, UNITED KINGDOM

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1. On 9th and 10th March, members of the Sub-Committee on Transatlantic Economic Relations visited London to discuss China's Economic Emergence and to gather information for a sub-committee report on the implications of China's Economic Emergence for Europe and the United States.

2. Sub-Committee members met with senior British government officials, members of the Treasury Select Committee who are also producing a report on China, UK business representatives and university professors. This short report will highlight several of the key themes discussed over the course of the visit. These ideas are developed more fully in the Draft Committee Report can be found at <http://natopa.ibicenter.net/default.asp?SHORTCUT=674>

I. THE CHINESE LEADERSHIP

3. The new leadership of China was strongly marked by the Cultural Revolution and places a strong priority on stability. Most of the top leaders have had scientific training and unlike the previous leadership generation, they have not had a great deal of international experience. Their scientific background informs their tendency to apply scientific models and rational approaches to government policy making. They are not ideological. They are also somewhat more socially oriented than the previous leaders who were very market oriented. Last year, for example, the government announced the first increase in poverty in 30 years. This was a conscious decision to focus attention on social justice matters, a set of issues that was not a priority in the early year of the economic boom. This social orientation also informed a recent decision to raise domestic agricultural prices.

4. Unlike Indonesia or many African states, corruption is not a problem among the top cadres of the Chinese state. Yet corruption is a central national problem at lower and at provincial levels of government, and has begun to seriously impinge upon the country's capacity to deal with a range of challenges including environment and disease control. The SARs outbreak, for example, was hidden by low-level officials who saw no upside to reporting the pandemic.

5. All this suggests that the Chinese state is neither as strong nor as compact as is often assumed. It remains highly opaque and the lack of alteration among the ruling elites makes the system highly susceptible to corruption. The top leadership remains terrified of social chaos, or economic upheaval that might trigger a challenge to one party rule. For this reason the Communist Party will brook no real opposition. Civil liberties are thus very seriously curtailed whenever movements appear to be evolving toward some form of opposition. That said, the area of human liberty in China has expanded significantly. British officials do not believe that the Communist Party hegemony is sustainable given the rapid changes it is undergoing socially and economically.

6. The new generation of Chinese leaders, while dedicated to continued economic development, is also paying greater attention to social fairness and development. These were issues that the previous generation had essentially put on the back burner for the sake of economic expansion. Still, continued Communist Party supremacy remains the core aspiration of the authorities that see in economic development the primary means for

achieving this. There is no longer a place for Communist ideology in contemporary China. If anything, consumerism has become the new creed.

II. THE ECONOMY

7. Chinese leaders are very aware that they preside over a developing country fraught with transitional problems including a swiftly widening wealth gap despite a massive reduction in poverty stemming from China's stunning economic growth.

8. The government is currently very worried about overheating, and has taken administrative measures to slow the economy down. Several sectors—construction, cement, steel, automobiles and property—increasingly seem over invested, and the government is struggling to rein these trends in with limited success. China's sheer expanse is part of the problem, and cooperation between central and provincial authorities is not as close as is often thought. Officials in the provinces, to take one example, are hardly eager to sign on to policies designed to slow down growth and property speculation. Provincial governments, in fact, are part of the problem and have been borrowing huge amounts of capital from state banks to engage in speculative investments.

9. China has opened its economy up to an extraordinary degree. It has taken its WTO commitments very seriously although implementation has been uneven. International investors have generally been very pleased with the government's approach, although there remain areas of dispute. Some trade barriers have been raised despite the overall movement to lower impediments to trade. The financial services sector remains one area of concern, with foreign banks confronting barriers to expansion. Under WTO rules, this market will have to be opened up within two years. There are also some problems in the automobile and construction sectors. Compliance with intellectual property rules represents yet another ongoing challenge. Although the Central government has introduced strong intellectual property protection legislation, implementation is very uneven across the country. According to one speaker, the EU itself has launched some 80 anti-dumping cases against China, but this does not reflect how far China has come in opening its market to imports. The rapidity of change is in large measure due to the fact that when the Chinese leadership is united in a decision, they are positioned to move very fast to implement it at least formally. Democracies can sometimes take longer as has been evident in India where even small decisions are liable to long drawn out debate. According to the speaker, this hardly suggests that centralized technocratic governance is superior to the give and take of democratic politics, particularly because the Chinese Communist Party also has the power to implement poor policies in an efficient manner.

10. China is not only an importer of capital. It is increasingly investing capital abroad, most notably in raw materials. The rational has certainly a great deal to do with strategic concerns about secure access to vital production inputs. The problem is that Chinese investors are paying very high prices for these assets at a moment when raw material prices are extremely high. A fall in global prices could make these investments look like very bad deals, and so they are one source of uncertainty in China's economic landscape. Some Chinese investments are generating tension with the West. China's energy investments in Africa, for example, have put some Western energy firms in a dilemma, as they are increasingly competing against Chinese firms willing to pay top dollar for

exploration rights. These firms also have business interests in China and find themselves in an uncomfortable position as a result. Chinese oil deals with Iran and Sudan have generated some anger in the US, and some have argued that China's views in the UN Security Council are increasingly conditioned by this asset purchase strategy.

11. Enforcement of court judgments in China remains quite difficult. There is no doubt that business is still dependant on political consultations. The Chinese economy also confronts several long-term risks. The growing gap between rich and poor is generating mounting social tension in China and the lack of democratic politics gives the state few means to vent this pressure. (Editors note - The apparently officially sanctioned anti-Japanese protests of recent weeks might be understood as an effort to vent this pressure). This problem partly explains the governments renewed focus on social matters.

12. Geographical divisions in China are also apparent; Eastern China is in the midst of a rapid economic expansion while the West is more impoverished although parts of the West are now undergoing an initial stage of economic development. Large areas of the country, however, remain thoroughly undeveloped and there are regions of the country where hunger and lack of water remain a serious concern.

13. Unemployment is also a problem. Authorities have closed or privatised an enormous number of state owned enterprises and many Chinese have lost their jobs as a result. The hope is that rapid private sector expansion will take up slack in the labour market, but it must expand at a very fast clip to do so. Some estimate that there are 150-200 million Chinese who are effectively surplus labour—that is to say they are at the very least underemployed and easily persuaded to move to the country's urban centres to find work. There are no accurate figures on the level of unemployment, but it is clear that millions of Chinese are effectively underemployed.

14. China has made huge strides in its education system over the last twenty years. The government has reformed the university system and its top universities are globally competitive in science and mathematics. Education is recognized as vital to moving up the production scale and securing greater future prosperity. The sheer size of the educational system is stunning. There are more students of the English language in China than there are British subjects living in the United Kingdom. The government has recently invested significant resources into the university system with the expectation that highly trained technocrats are needed to keep China growing. The soft sciences continue to suffer under the burden of political restrictions

15. The banking sector is also very vulnerable because of a pattern of high risk lending. Chinese banks hold considerable non-performing loans on their books including many loans to failing state owned concerns. Some have estimated that non-performing loans are the equivalent of 30-40% of GDP. An economic downturn could well trigger a serious financial crisis because of this debt overhang. Chinese regulators are well aware of the problem and are looking to western experts to provide expertise and support for bank reform. Privatisation is one solution, although the largest banks are likely to remain in state hands, at least until some of these loans are written off. Foreign Banks are not interested in purchasing large banks burdened with bad debt; they are focusing more on the smaller and healthier institutions that are being put on the market. China's banking sector also lacks adequate capital and expertise. Accounting standards in the corporate sector

generally remain inadequate as do economic statistics and both make the task of bankers all the more difficult. This adds a further degree of economic risk. Raising the presence of foreign banks in China would help on both fronts.

16. China's monetary authorities continue to tie the Renminbi to the dollar and have derived some commercial benefits from the dollar's recent decline. They are not prepared to move with haste to a free-floating currency. The Chinese also lack the transparent institutions needed to manage open capital market fully. The People's Bank of China holds some US\$ 400 billion of foreign exchange reserves. A revaluation would result in a massive write down of these assets. This would lead to a capital adequacy crisis across China's banking sector. Moreover, an additional US\$ 190 billion is held by enterprises and households in deposit accounts at Chinese commercial banks. A sudden revaluation could thus precipitate a genuine financial crisis in China with important potential spill over effects.

17. China has very rapidly emerged as a global economic power. It recently overtook the United Kingdom to become the world's fourth largest exporter, and since 2003 has been the third largest importer. It now accounts for 25% of the world's steel imports and 8% of the world's energy imports. This could rise to 25% by 2020. In both 2003 and 2004 China was the world's leading destination for Foreign Direct Investment (FDI).

18. It is thus not surprising that China's trade surplus of \$25 billion is only 3% of its overall trade. China's very large trade surplus with the US, however, is posing diplomatic problems. That surplus can be attributed in part to relocation of US manufacturing to Chinese cities as well as America's overall macro-economic posture. The domestic value added content of Chinese exports to the US is very low at 20% while the corresponding value added content of US exports to China is very high. According to one economist, who spoke to the Sub-Committee, if one looked at the trade balance in these terms then the US would enjoy close to a ten billion dollar surplus with China. This also suggests that an appreciation of the Renminbi would not be very likely to have a strong effect on the general trade balance between the US and China. Accordingly a ten percent appreciation would only have a 2% impact on reducing exports to the US. This same problem has cropped up before in disputes between the United State and Japan over the value of the Yen. Yen appreciation has never significantly reduced the Japanese surplus with the United States. The core reason in both cases is the saving- investment imbalance in US. China has effectively been lending capital to the United States and allowed it to keep interest rates lower than it otherwise would have, given its serious budget problems. It should also be noted that China has large trade deficits with Taiwan, Korea and several other Asian states. It is importing both sophisticated components and capital goods from these countries.

19. China confronts other long-term financial difficulties. Because of its one child policy, China is an aging society and needs to devise a sustainable pension system—a task that poses a serious financial and organizational challenge. The burden now is falling almost entirely on families, but with so many one-child families, this is not a sustainable long-term solution.

20. As suggested above, last year authorities put up the prices of all agricultural products by 30%. This was designed to slow migration into China's ever more crowded urban areas

and essentially affect a wealth transfer to the countryside. For the moment the gambit appears to be working; the farming sector has begun to absorb some of the excess labour that has been flowing into the cities. It has also stimulated a domestic economy which has been relatively moribund compared to the explosive growth of the trading sector. This is providing a backstop for the manufacturing sector.

III. NATIONAL SECURITY AND DIPLOMACY

21. On the international Front, China's relations with Taiwan poses one of its most intractable problems. The National People's Congress has recently passed a law that will allow the use of military force if Taiwan declares independence. China has thus made it very clear that were Taiwan to renounce its "One China" policy, the mainland would not rule out military action as part of its response. According to several speakers, Taiwan remains a highly emotive issue in Chinese politics, and no leader of China could be seen to be weak on the matter. The real question in the eyes of many is whether the new policy reflects a genuine military shift, or is simply rhetorical. China would certainly stand to lose a great deal both economically and diplomatically were war to break out in the Taiwan Straits.

22. The new law has also provoked European reassessment of a recent decision to abandon a long-standing arms embargo imposed after the Tiananmen crackdown. Various speakers to the Sub-Committee differed on the possible effect of the embargo, with some suggesting that the issue was more symbolic than of strategic consequence. British officials have been consulting closely with the United States on the matter, and at the time of the visit, asserted that they did not judge that switching to a new code of conduct would result in any rise of arms sales. (Editor's note—A number of European governments have subsequently begun to back away from support of an immediate end to the embargo.) British officials are also firm in their position that China will have to make more progress on the International Convention for Civil and Political Rights to see through any change in the embargo. Russia continues to be the most important supplier to the Chinese military. But several members cautioned that the Chinese are also dedicated to modernizing their military and suggested that caution was also needed. China's relations with its neighbours were also discussed. Several points came out of the discussions:

23. According to one analyst the Sub-Committee met, China has also effectively undermined the international economic embargo of Burma. China sees Burma as a client state through which it enjoys access to warm water ports. The Chinese are upgrading those ports that are also slated to be part of the Chinese energy network.

24. China sees North Korea as both a buffer state and a potential area of dynamic growth if its leaders are willing to open the country up further. One economist that the Sub-Committee met suggested that North Korea is changing very rapidly and could eventually become a key Asian manufacturing centre. Chinese officials do not welcome any discussion of regime change and this is a source of tension with the American Administration. China is currently supplying most of the energy and a great deal of food to this isolated country.

25. China is also playing a very active role in Central Asia. It is participating in the Shanghai Cooperation Organization with Russia and four Central Asian Republics: Kazakhstan, Kyrgyzstan, Tajikistan and Uzbekistan. This group was set up in 2001 to advance confidence building and arms control measures. The Chinese see the Shanghai grouping as one of several means to resist growing separatist movements it confronts in its own western regions. For China, Central Asia is an important potential energy partner and Chinese firms are very active in Kazakhstan's oil and gas sectors where they are investing heavily.

26. Chinese relations with Russia have improved substantially in recent years. Both sides see their relationship as being a major strategic asset and one means to resist US influence.

27. In Asia itself the Chinese are increasingly active in promoting regional economic integration. Trade in the region is exploding, and China has become the preferred location for final manufacturing for many of the region's producers. The problem is that the country is so big and so dynamic that it is almost invariably seen as a threat in the region.

IV. ENVIRONMENT AND ENERGY

28. China is also burdened by serious environmental problems due to the dizzying pace of industrialisation and inadequate environmental infrastructure and regulations. The core problem is that China is rapidly becoming a mass consumer society, but it lacks the basic infrastructure for coping with the waste this level of development generates. As a result, very little waste is properly treated in China. Some improvements have been registered in showcase cities like Beijing, but provincial cities have seen little or no improvement. Again, the top priority remains economic growth and the environment was long relegated to an afterthought.

29. This is beginning to change. Chinese officials have adopted the rhetoric of environmental protection, pledged funds for environmental projects, passed relevant legislation and even signed up to Kyoto. But implementation and enforcement has been very patchy at best. As a developing country, China has no obligation to meet its emissions quotas until 2012. Yet it is presently the largest producer of ozone in the world. To their credit, Chinese officials are reaching out to the international community for support in these areas and the World Bank has developed a number of environment related projects with the government. The West has a very strong interest in China becoming a more efficient energy user and generally more environmentally conscious and this is one of many justifications for a policy of engagement.

30. China's energy needs are daunting. On the one hand, the government is intent on using cleaner fuels including gas from its Western provinces and Central Asian neighbours. Yet coal will continue to play a central role in meeting the country's ever mounting energy requirements. At the same time automobile use is growing at a very fast pace. During SARS crisis, the government essentially conceded to broader use of automobiles. This led to a surge in sales that has only augmented traffic, environmental and long-term energy challenges.

31. Northern China's very serious water problems are not evident in Beijing but the effect is profound and there are also rising energy shortages in the region, which are also affecting life in the capital city. Within 50km of Beijing, there are millions receiving food aid because of persistent drought conditions. Energy shortages are also evident and are likely to place a limit on Chinese economic growth. Already many firms need to purchase auxiliary power sources because of rising power shortages. The problem became fully visible last summer when authorities in Beijing were faced with a choice of either switching off the air conditioning or the factories. Air conditioning won out.

32. One speaker at London University suggested that there are three time horizons with which one should reflect on China's energy challenge. There is a one-year perspective; here whether the year will be very hot or cold is crucial. The medium term perspective of 4-6 years hinges on China's capacity to build new generating capacities. The long-term perspective is conditioned by securing access to energy.

33. Energy markets have undergone a radical transformation in China. In the early 1990s, the growth rate of energy consumption stood at about 9% and then it fell to 6%. For the last three years, energy demand has risen up to 15% per annum. This has vastly exceeded the expectations of authorities. The elasticity coefficient of energy demand is also very large. In Western countries that coefficient has been less than one. In China last year, it was 2. In other words, China needed two additional increments of energy to drive an additional increment of growth. The problem has become serious and China's State Council has had to rewrite its energy plans several times to account for unanticipated leaps in energy demand. There is little doubt that if China continues to grow at its current pace, it will confront serious energy constraints in the near term because of the lack of energy infrastructure capable of supporting that growth.

34. Currently foreign imports account for one third of China's overall energy supply although there is substantial oil smuggling as well, and these imports do not appear on the books. These imports are effectively tipping the balance of global oil markets. China needs to intensify efforts to produce more of its own energy in order to encourage energy conservation. It uses a great deal of coal and, if anything, this will increase over time.

V. MEETING WITH TIJDAN THIAM OF THE COMMISSION FOR AFRICA

35. The Delegation had an opportunity to meet with Tijdane Thiam, a member of the British Africa Commission. He spoke to the Sub-Committee the day before the launch of the Commission's report, which was designed to provide a road map for Western relations with Africa at a moment when the UK is to hold the Presidency of both the G8 and the EU. The Commission is chaired by the British Prime Minister Tony Blair and includes several eminent Africans, as well as prominent members from G8 countries.

36. Thiam discussed the work of the Commission, the myriad consultations that have provided the background for the report, its focus on governance and human development. Two critical themes in the Commission's work have been the ultimate responsibility Africans bear in shaping their own destiny and the need for the West to provide an international context to make this possible. More specifically, the developed world needs

to open up its markets to Africa and not distort agricultural markets through export subsidies. Western companies should also ensure that their own policies are not contributing to regional insecurity. At the same time African leaders need to endeavour to ensure good governance and reduced corruption.

37. On the security front, the African Union has played a very important role in regional peace building, and the West needs to support its work. Security remains one of the critical problems in Africa, and a genuine roadblock to economic development. Foreign investors will not invest in countries at war, and are not even likely to invest in countries in regions where fighting has broken out. There are thus very high economic stakes in settling the problem of African insecurity but at the same time, trade and economic integration are keys to stability.

38. Corruption also represents a serious impediment to positive change in Africa. In “non-linear traditional societies”, one might make the case that using the exchange of favours as a tool for political organization might work. The problem is that this utterly breaks down in a globally integrated setting. Tribalism is part of Africa’s problem but there are ways to transcend this, in part, through education.
