

**Bankers Trust  
Company**  **Country  
Assessment**

**International Economics**

280 Park Avenue, New York, N.Y. 10017 U.S.A.

---

**POLITICAL RISK IN CHINA**

**William H. Overholt  
Vice President  
Political Assessment Group**

**PAG 130/1-D      13 December 1982**

**DRAFT**

This is a working document and is not in final form; the statements contained in it may need to be revised or corrected. It is reproduced for private circulation only, not for general distribution or publication, and it should not be cited or quoted without the permission of the author.

Drafts are reproduced at the discretion of the author, with no Bank review procedure, and thus no opinions, statements of fact, or conclusions contained in this document can be attributed to the Bank or its clients.

## POLITICAL RISK IN CHINA

China's post-1949 history has been characterized by wild oscillation between periods of pragmatic management and sound growth on the one hand and periods of ideological mismanagement, disorder, and anti-Western radicalism on the other. The results have been extremely unfortunate for China's economic advancement and unhappy for its aspiring economic partners. However, the current period of pragmatic management is likely to persist. Moreover, even at the height of Cultural Revolution disorder, China honored its economic and financial obligations. There is virtually no foreseeable risk from Chinese repudiation of obligations and minimal risk of massive financial mismanagement.

The Chinese economy is still extraordinarily primitive. Eighty percent of the population is still in agriculture, earning an average daily income of U.S. \$0.27. Chengdu, the capital city for Sichuan's 100 million people, has one civilian telex machine, which can send but not receive. Some provinces remain completely devoid of major roads. Widespread malnutrition and some starvation still occurred through the mid-1970s. These problems are exacerbated by Chinese failure to invest heavily in human capital, and particularly by the almost total breakdown of the educational system from 1966 to 1976. Many managers at senior levels lack the qualifications that would be expected of a Bankers Trust trainee. The economic problems are further compounded by a command economy, which until recently has provided almost no incentives for efficient production, and by a Stalinist system of priorities, which has funneled the funds into expensive nuclear weapon programs, fantastic steel complexes, and a machine tool industry capable of exporting to the United States, while leaving most light industry and agriculture in a pre-modern condition.

Since the death of Mao Tse-tung in 1976, and particularly since the third plenum of the Central Committee in 1979, China has made important progress toward remedying some of these major difficulties. Agriculture and light industry now have priority over heavy industry, and heavy industry is being reoriented to support light industry and agriculture. Energy, communications, transportation, and education are being given the priority they deserve. Stern population control measures are beginning to break the increase in China's one billion plus population. Economic policy is pragmatic and steady, rather than ideological and fluctuating. A system of profits and bonuses is beginning to provide incentives for institutions and individuals to work more efficiently. Decisions are being made by bureaucracies rather than by mass social campaigns. Professional skills, rather than radical ideology, are becoming the criteria for promotion to management responsibilities. There is a significant effort to collect statistics systematically and professionally and to undercut the incentives for dishonesty which have previously rendered China's statistics nearly useless. These changes are just beginning, and China's economic system remains primitive, over-bureaucratized, and ridden with ideological rigidities to an extent that would not be tolerable in China's non-communist neighbors, but, compared with the past, these changes have been so dramatic as to ensure significant progress and to create a political base for further progress.

The changes have been most dramatic in agriculture. Key management and planning responsibilities have been drastically decentralized. The production brigade, rather than the commune, is the principal unit of management responsibility. Production is organized around contracts with individual families, rather than large groups, and individual households are allowed small private plots. Through a system of individual bonuses, brigade retention of profits, and limited right to sell surplus produce at free markets, the new system provides incentives for harder work and more efficient production. Limited, but significant, increases in the rights of local units to determine what they will produce and how, provide some flexibility and freedom from rigid central controls. Together with a major reduction of taxes on agricultural producers, these changes have elicited an enthusiastic and productive response from China's 800 million farmers. Agriculture is the great success story of the new economic program.

Light industry has been given priority over heavy industry. Firms have been delegated the limited right to establish their own mix of products, and to tailor individual products to consumer demand. (Everywhere in China one now sees bright, colorful clothing rather than just the old blue uniforms). They are allowed to retain some profits and must pay their own cost of capital, in contrast with the old system where the state provided all capital at no cost to the firm and then received the entire production of the firm. Individual workers receive bonuses, and firms receive significant benefits, when production exceeds quotas. The results have been an extraordinary takeoff of light industry and the decisive emergence of a consumer society, albeit at a very low level.

The new enthusiasm for light industry has two unwanted side effects. One is over-investment by inexperienced managers and others in ill-considered enterprises. These investments have been the cause of local embarrassments and inflationary pressures, and they had to be cut back in a reassertion of greater central control. Second, the new market orientation of light industrial firms has been cramped by China's system of controlled prices; command pricing still frequently rewards sectors which were lucky in past price decisions, rather than firms which are most efficient or most oriented to the needs of the market. Their successes also constrained by the continuing difficulty of disciplining or dismissing errant workers, even though discipline and dismissal are now officially permitted, and by strong rules against one firm's offering a job to a worker from another firm.

In lower priority heavy industry, introduction of individual and group incentives has been more difficult because responsibility for an increase in production is so diffuse. But the system has been implemented to the extent possible. China's high technology firms are extraordinary for their excessive purchases of machinery (due to past lack of responsibility for capital costs and to difficulties in obtaining spare parts), for the huge number of workers required to undertake a given task, and for bottlenecks of energy, communications, and transportation. Nonetheless, heavy industry, for which only one percent growth was planned in 1982, has achieved 9.8 percent growth, straining energy, communication, and transportation systems even further.

The Chinese economy under this new system continues to be constrained by rigidities in pricing and use of labor, and limited by the huge share of production which still is taken by the state. Subsidies remain on a broad range of consumer goods. But the improvements in the system should be sufficient to generate steady growth. The plan for 4-5 percent annual GNP for the rest of the decade is sober and probably attainable.

The new economic system generates a great deal of support for itself. Farmers receive extraordinary benefits from the incentive system, and from the tax cuts. Industrial workers and managers receive smaller, but very significant benefits. To the extent that economic performance improves, government managers and top level Party personnel receive benefits. Farmers in particular feel so strongly about the new system that any attempt at reversion to the ideological system of the Cultural Revolution would risk triggering a massive and widespread peasant revolt. This, together with near universal revulsion at the violence and economic setbacks caused by the Cultural Revolution (which was a far greater upheaval than anything that has occurred in Iran) ensure that there will be no reversion to the extreme ideological policies of the past. Mao's old radical alliance of himself, old revolutionaries, ideological party officials, academics, media people, and youth cannot be re-established without the charisma of Mao and the massive support of old revolutionaries who are now dying off.

At the same time, progress toward implementing and broadening the system will not necessarily be smooth and uninterrupted. The new economic policy keeps military budgets small and thereby ensures that, for the remainder of the decade at least, China's military will remain primitive and incompetent in comparison with its Soviet challenger. The new profitability of farming makes it difficult for the military to attract adequate recruits. Second, middle and lower Communist Party officials have lost most of their previously dominant influence over economic management and therefore are undoubtedly dissatisfied with the new system. Third, the Cultural Revolution generation of youth, which lacks all education and training, is hopeless in a period of emphasis on professional skills, and will remain disoriented and unhappy for the indefinite future. China is beginning a three year rectification campaign to clean ideologically unacceptable and professionally incompetent people out of the Communist Party. There has been a massive reshuffling of top military officials in recent months. The enthusiasm of farmers for the new system ensures that eventually the Communist Party will have to put on the brakes. Therefore, ferment will continue in Chinese politics, and there is some risk of significant setbacks and a need to accommodate military demands for greater military spending. But, on balance, there is no likelihood of return to past upheavals and ideological policies. The Chinese revolution is coming of age, China's organizations are becoming institutionalized, and a generation of managers is replacing a generation of revolutionaries.

In such a context, China's creditworthiness is excellent. Although China disavowed responsibility for the obligations of the pre-Communist regime, its record since then has been one of extremely conservative financial management. China abhors excessive debt. China finds any significant inflation intolerable. Like other Third World countries, China has enmeshed itself in a series of subsidies, but its attitude toward inflation makes those subsidies

more manageable than elsewhere. Like other Third World countries, China's initial plans for investment and growth after Mao's death were excessive, but, unlike most other Third World countries, China quickly realized this and backed away before facing financial trouble. China's record for honoring financial obligations is spotless. Even during the hard times of the Great Leap Forward in the early 1960s, at the height of the Sino-Soviet dispute, China paid the Russians for debts incurred on entirely unreasonable terms as a result of China's purchase of Russian arms for use in the Korean war. In a Third World context where most countries are now over their heads with debt, and in which even many of the star performers like South Korea face a period of lower growth and financial retrenchment, China offers the prospect of steady, although unexciting, rates of growth in a conservative financial environment with great creditworthiness.