

# BT Brokerage Research

## China's Power Struggle And Hong Kong's Future

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The panic in Hong Kong, particularly its stock market, over the power struggle in Beijing, is the latest in a long series of overreactions. What is happening in Beijing is just the latest round in a long struggle, and, despite the regrettable victory of the old guard, the struggle will have minimal economic impact on Hong Kong. Over the longer run, Deng's victory will prove Pyrrhic and the liberalizers are likely to win.

China's modernization repeatedly devours its leaders. The Chinese tiger is simply too large and unruly for any individual or small group to ride for very long. Recent victims have included Chen Yun, who reformed too slowly; Hu Yaobang, who moved too fast; and Zhao Ziyang, who first lost his economic clout for reforming the economy too fast and then his political position because of excessive sympathy for the democratizers.

Each time a major figure loses his balance, Hong Kong panics. When Hu Yaobang fell, Hong Kong's press declared disaster and the stock market fell. Likewise with Zhao Ziyang. And Hong Kong has been working up for years toward an all-out panic on the occasion of Deng Xiaoping's death or disability—except for last week, when everyone suddenly wished Deng would fail. Three weeks ago, the stock market would have collapsed if Deng had fallen; last week, it was determined to collapse if he didn't fall.

The repeated declaration of the death of the Chinese reform program and of dire consequences for Hong Kong's economy flies in the face of the economic indices, which head ever higher for both Hong Kong and China despite the political crises. It is likely that the same will hold true of political reform; in the aftermath of Hu Yaobang's fall, who would have imagined that China would tolerate mass demonstrations in Tiananmen Square for even a few hours, that transcripts of Politburo debates would circulate, that foreign television cameras would be allowed to document everything, and that Taiwanese writers would report from the scene?

The dire forecasts have been based on a number of largely subliminal and utterly erroneous images.

A frequently repeated fear has been that political turmoil would bring radical groups back to power. This fear fails to comprehend the universal revulsion caused by the Cultural Revolution against radical ideology. The Cultural Revolution's impact on Chinese society was like smallpox: if it doesn't kill you the first time, you're immunized forever.

None of China's major political factions is radical. The old guard faction is comprised of the bureaucratic dinosaurs who want China's economy and politics both to be run like the U.S. Postal Service. They are the antithesis of anything radical. Then, led by Deng Xiaoping, there are the semi-totalitarian reformers. They seek to run politics like the post office but want considerable introduction of markets to the economy. For them, political reform is confined to anti-corruption campaigns and a limited effort to distance enterprise management from Party control. Finally there are the liberalizers, who advocate broad freeing of prices, widespread privatization of enterprise, and an amorphous agenda of political liberalization including freedom of speech and press. With civilian and military variations, these exhaust the major factions. There simply aren't any serious radicals among them.

Second, many fear that China's economy risks being shut down by student protestors in the manner of Poland after August 1980. But China has 800 million autonomous farmers who are widely dispersed and highly motivated by profit incentives; student protests won't shut them down. Nor will it shut down China's industry which, unlike Poland's, is highly diversified and spread out over much of a continent. Poland's economy was crippled by a workers' movement which was highly organized and devoted to a strategy of economic warfare. China's protest movement has neither a comparable organizational structure nor a comparable strategy. In fact, China's economy was relatively unaffected except for a few minor problems such as misallocation of railroad cars needed to carry coal.

China's problem is not economic stagnation but overheating. Today, as before, the biggest problem Beijing faces is to slow the economy down to manageable levels of growth.

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Related to this fear of economic immobilization was a fear of prolonged fighting between students and army, of "blood in the streets." This was based on a complete misunderstanding of the situation. Haphazardly organized students are never, under any circumstances, a significant challenge to an army with clear orders and willing to act. The student protests flourished in a vacuum where divisions within the Communist Party prevented the issuing of coherent, unified orders to the army. So long as the Party could not achieve a unified decision, there would be no blood in the streets because the army would not act. As soon as the Party was able to decide, there would be no blood in the streets because the students were rational and knew they could not stand against the army. China is not the Philippines (1986) with a completely demoralized and incompetent army.

Serious risks would arise not from a student/army confrontation, but from a complete breakdown of Party discipline and subsequent confrontation of army units mobilized by competing Party factions. Ironically, at this point such a risk would arise primarily from some event that suddenly shattered the conservative coalition. Deng Xiaoping's death or incapacitation might do that.

Third, many commentators have expressed fears that China would be bankrupted like Yugoslavia. One overwrought commentator wrote that, "China is running out of money." But China, unlike Yugoslavia, Romania, and Poland, has large foreign reserves (US\$18.5 billion foreign exchange plus \$4.5 billion gold in December 1988) and one of the lowest debt service ratios in the Third World: 6.5% for 1988, compared with a bankers' standard that 20% is moderate. And China is not vulnerable to large capital outflows.

A fourth concern was that China's troubles would cripple Hong Kong's exports by shutting down Hong Kong firms' production in China. Since Chinese firms' production was not crippled, and since Hong Kong firms' Chinese production is concentrated in Guangdong, far from major centers of protest, this theory made little sense. Nonetheless, throughout the crisis, we surveyed the major Hong Kong firms with factories in China. None had its production impeded; none experienced significant inconvenience or even threat of significant inconvenience.

Seemingly more substantial was a fifth concern that China would cease to demand Hong Kong's exports. But 48% of Hong Kong's exports to China are for onward processing; that is, they are inputs for goods destined for OECD or Asian consumption outside China. Hong Kong exports to China primarily to make Walkmans for ladies in Tokyo, not washing machines for ladies in Beijing. And no Chinese government, particularly one run by conservatives perennially paranoid about foreign reserves, would want to impede such trade. Unlike Poland's, Guangdong's workers and managers have incomes tied to productivity, which has been rising fast, and they will not abandon their improving lifestyles to make a political point.

Indeed, such is the momentum of Hong Kong's economic intercourse with China that the first quarter of 1989 saw approved foreign investment in Guangdong (most of which comes from Hong Kong) increase 120 percent over 1988 despite a determined austerity program imposed by China's conservatives. Hong Kong's domestic exports to China rose 35 percent and reexports rose 50 percent. The things that Hong Kong makes for China have particularly resilient demand given China's ongoing growth: batteries by Gold Peak and televisions by Luks will continue to sell despite a range of difficulties.

A sixth major fear is that the whole range of promises to Hong Kong from China would come unstuck and that 1997 would see a communist debacle. But all major factions in China share in the consensus that Hong Kong's prosperity is essential to China's development, as well as to Beijing's program for seducing Taipei, and that continuation of Hong Kong's present economic and legal system is a prerequisite of prosperity. If the Draft Basic Law had provided for thoroughgoing democracy, there would be ground for concern. But it doesn't; the footprint of the dinosaurs already lies heavily on the Draft. The real question is whether the Beijing Spring will inspire some of Hong Kong's hitherto cynical elite to get out of bed with the dinosaurs.

Then there is the ultimate terror, namely that in its distress China will abandon the open policy altogether. Once again, a little factional analysis clarifies the issue. The liberalizers draw their life and courage from the open policy. Deng Xiaoping's group is the author of the open policy, and he is as committed to economic opening as he

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is to political closing. And Li Peng, speaking for the dinosaurs, has emphasized in his major pronouncements that the justification for martial law is the need for political stability in order to protect the open policy.

Does anyone truly believe that China could take back the land from 800 million farmers? Or that it is politically capable of closing its borders once again? Or that China could return to an economy devoid of competition or material incentives or small scale free enterprise? Some people outside China may believe such fantasies, but Li Peng doesn't. The issue in China is how fast to move forward, not whether it is possible to move backward.

This is the key to understanding China's modernization and its implications for Hong Kong. China continues to lurch from crisis to crisis. No leader, not even Deng Xiaoping, can ride the Chinese tiger indefinitely. No leader can modernize its economy without dizzying rushes of inflation and foreign exchange outflows. But the trough of each crisis is invariably higher than its predecessor and the peak of each effort at economic and political modernization is far higher than its predecessor.

Not so long ago by Chinese standards, Deng Xiaoping began his efforts to use markets and an opening to the world to advance China's economy. He was given the full treatment by the dinosaur faction and the radicals. Now he has given the full treatment to the next generation, which would like to complement economic modernization with political reform. Just as the dinosaurs won a total victory over Deng, for a time, so Deng appears to have won a total victory over Zhao, for a time.

That time is likely to be short, a few years at most. China's students have captured the national imagination. China's intellectuals, always a weak force in the short run and always overwhelming in the long run, have abandoned Marxist cliches and, to a degree that seemed impossible just a few years ago, raised a generation of pragmatic

youngsters. The intensity of the distaste expressed by much of the Chinese population for the bureaucracy has to be experienced to be believed. On the other side, much of the party and army establishment, even including the venerable Peng Zhen, have indicated unmistakably that they are troubled by the conservative crackdown. As this is written, Statue of Liberty East still stares Mao's portrait in the eye, indicating a certain indecisiveness among the conservatives. Those groups that represent China's future are sold on change. The conservatives have won the battle, but the liberalizers are best positioned to win the war.

Indeed, much of the Chinese struggle must be seen as generational, not just ideological. Deng's brand of pragmatism was able to surface only after Mao's radical generation died off. Li Peng represents a generation of Soviet-trained engineers that has been steadily working upward for decades. The liberalizers have their roots in an elite educated in the West that is much too young to take power but is far broader and deeper and more enthusiastic than Li Peng's Soviet-educated stratum. They will take over in China just as they did in Indonesia. And when they do, their victory will be permanent, as elsewhere in Pacific Asia, because they know how to deliver economic benefits.

China will continue to devour its leaders. Its economy and politics will lurch around, frightening Hong Kong and its stock market. The lurches will worsen emigration from Hong Kong, but not fatally, and will even occasionally cause the property market to take a deep breath before continuing onward. But the lurches do, in the end, follow an economic trend: upward, faster than virtually all the other economies in the world. That trend is likely to persist, and most of the foreign investment, financing, trade, and technology purchases associated with that trend will continue to go through Hong Kong.

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