Going with the Flow  

The Political and Economic Fundamentals of Doing Business in China

For years, the Western business community has understood that East Asia will be a source of enormous demand for its goods and services. In the last five years, China has been heralded as the crown jewel of all the emerging markets, with its double-digit growth rate and rising per-capita income on a large population base. China has also been touted as a top site for foreign direct investments (FDI). Since 1993, China has been the largest recipient of FDI among developing countries, attracting attention not just from small apparel producers in Asia but also from such corporate heavy-weights as GM, Xerox, and Motorola.

The Risks

The ongoing economic and financial crises in East and Southeast Asia have raised the awareness of the risks of doing business even in a high-growth region such as Asia. The “Asian miracle” proved to offer no immunity from three kinds of common risks of investing and doing business abroad. These are economic risks, political risks, and operational risks. Economic risks are those that threaten to reduce the returns of investors, such as inflation or a sudden exchange-rate devaluation. Political risks refer to those risks that result from social instability or sudden, adverse changes in the leadership. There are a variety of operational risks, including loan defaults, other payment problems, or bad business partnerships.

This article will examine the economic and political risks which investors or businesspeople may confront in China. In the aftermath of the financial crises in Korea, Malaysia, Indonesia, and Thailand, the business community may view China as a more risky proposition than before and may re-think their approach to China. Although one should never discount economic and political risks altogether, the central theme of this article is that Chinese economic and political fundamentals remain basically sound.

Economic Fundamentals

In the wake of the Asian financial crises, business pundits have predicted a similar sce-
nario for China. They take note of the fact that a large portion of the assets in the Chinese banking system are non-performing, creating a situation, they argue, similar to or even more severe than the banking difficulties in Southeast Asia, Korea, and Japan. Experts also forecast an inevitable devaluation of the Chinese currency because the lower value of the Southeast Asian currencies makes Chinese goods less competitive.

These views are overly alarmist and too simplistic. It is true that many of the loans to the state-owned enterprises (SOEs) are non-performing and that, as a percentage of total bank assets, the problem of non-performance is more serious in China than in some of the most severely affected Asian countries. The Chinese banking system, as many have pointed out, is technically bankrupt. However, there are significant differences between China and other Asian countries in terms of the fundamental root causes that have given rise to the problems in the banking sector. The similar outward symptoms stem from very different causes and this difference means that it is unlikely that China will experience a full-blown crisis of the scale of Indonesia, Thailand, and Korea.

The first significant difference is that in China, when banks made loans to SOEs, it was with the explicit recognition that these loans were to serve the important social and political obligation of keeping unemployment down and maintaining political stability. Thus expectations were such that the loans would be non-performing. The role of expectations here is crucial. Banks in Korea and Southeast Asia expected, incorrectly as it turned out, that their loans would generate high rates of return so they borrowed heavily from short-term sources to finance some of their long-term loan obligations. Ironically, because the Chinese banks never had such expectations about profits, they never borrowed to the extent that banks in other Asian countries did. In the last three years, during a period of austerity policies, the banks even reduced their borrowing from the Chinese central bank as the central government restricted the money supply to rein in inflation. Indeed, the non-performing asset problem in Chinese banks is directly related to the shortage of liquidity in the system as firms default on each other in payments.

The second big difference between China and other Asian countries is that China still maintains stringent capital controls which keep Chinese firms and banks from borrowing directly abroad. This turns out to be a blessing for China as excessive borrowing abroad in other Asian countries, coupled with market distortions at home, directly precipitated the currency crises. Since Chinese banks' assets and liabilities are denominated in domestic currency, currency fluctuation does not have as big an impact on their solvency. This does not mean that there is no linkage between problems in the bank-

_ID like some FDI please._
ing sector and exchange rate. If problems continue to mount in the banking sector, Chinese depositors may decide to take their money out and this kind of panic run will produce pressures on the Chinese currency if the government decides to print money to meet depositors’ demand. This will have an inflationary effect and the Chinese currency will experience downward pressures. Probably for this reason, the Chinese government has decided to implement a complete overhaul of the Chinese banking sector. It is reported in the press that Premier Zhu Rongji has ordered a restructuring program in the banking sector to write off the bad debts and to re-capitalize the assets in the Chinese banks. This measure will likely generate upward pressures on the yuan as the government would need to increase taxes in order to re-capitalize the Chinese banks.

Is the Chinese currency under pressure? This is a risk that investors ought to consider when they invest in China since a devaluation of the currency would reduce investment profits in dollar terms. Many business analysts believe that the yuan is under tremendous pressures to devalue because China competes with Southeast Asian countries in export markets.

This overly simplistic view ignores many of the important differences between China and Southeast Asian countries. First, devaluation of the yuan will improve China’s export competitiveness only if other countries do not devalue their currencies. This is a big if and the Chinese leaders have made repeated statements that they will not devalue, indicating they are fully aware of the ill effects of competitive devaluation in the region.

Second, the yuan will be unlikely to be devalued in the short to medium term because, unlike Southeast Asian countries, China is huge and it encompasses regions of tremendously varying levels of economic development and income. As the costs in coastal provinces rise, firms can reduce their costs by relocation to the low cost regions in China’s interior. Indeed, this process has already begun. Many of the low-skilled labor-intensive operations have been migrating from coastal provinces to some of the interior regions in China to economize on labor costs. The currency pressures from Southeast Asian countries will only accelerate this process.

Will the downward pressures on the yuan originate from China’s capital account as foreign loan obligations become due and Chinese firms need to convert yuan into dollars to meet their debt obligations? One important reason that Southeast Asian countries are faced with debt problems is that they borrowed excessively on the short-term front. Short-term financing is expensive and often very volatile. In the area of short-term debt management, China looks quite good. The short-term bank borrowing turned negative in 1996; in other words, their payment exceeded their borrowing and the long-term borrowing by Chinese banks in 1996 was lower than the level in 1985. China actually has decreasing short-term obligations. According to the State Statistical Bureau, in 1996, its short-term capital account was in deficit meaning that China made more payments or invested more abroad than it borrowed.

The Asian financial crisis is a classic tale of “herd behavior” whereby investors first compete to get into the region when the economic prospects look good and then compete to get out at the first sign of trouble. China’s annual FDI inflows are a carefully monitored indicator of economic health. Some business analysts take comfort in China’s
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was in prison. Prisoner B said “I am in prison because I supported Deng Xiaoping.” Prisoner A replied that this was very odd because he was in jail for opposing Deng Xiaoping. They then turned to Prisoner C and asked why he was in jail. Prisoner C answered, “I am in prison because I am Deng Xiaoping.”

There was a lot of doubt about whether the post-Deng leadership would be able to maintain a degree of unity and cohesion and to continue Deng’s program of reform. Now one year has passed since Deng’s death and there is no sign of any paralyzing power struggles at the top echelon of the Chinese leadership. Economic reforms have not only continued, but will be significantly deepened.

In political as well as in economic arenas, the foreign business community is often misled rather than informed by the Western news media. Because of the exclusive focus on individual leaders and their actual or imagined policy differences, the Western news media have missed some of the far-reaching institutional changes which make today’s China a more governable country than before.

The first fundamental fact is that Chinese politics is stable today. This stability comes from a fundamental change in the nature of the Chinese political scene. In 1994, I argued in an op-ed piece in the New York Times that Chinese politics has become “polite”; that Chinese politicians have become political rivals rather than political enemies as they had been before, which augurs well for post-Deng stability—a point that turned out to be quite on the mark. Because of the Cultural Revolution, the Chinese leadership has established an implicit taboo among themselves against driving the political opponents to the wall. This is a world of change from the past when Chinese politics was nasty and brutal. Making politics more civil was one of Deng Xiaoping’s most important and underrated achievements.

The New Consensus

Political stability also comes from the extraordinary consensus among Chinese leaders about the general political and economic goals of the government. Their disagreements are no longer ideological in nature but rather technical, pertaining, for example, to the pace and sequence of reforms or the issue of inflation vis-a-vis unemployment, the kind of debate that Alan Greenspan could easily appreciate. They resolve these disagreements through compromise and negotiations. The consensus politics of China today vastly limits the scope of power struggles should such struggles break out. It also decreases the significance of any one individual leader in determining the general political and economic directions for the country; this makes politics more stable and more predictable.

The second fundamental is a transformation from power politics to interest politics. Many analysts are alarmed by the fact that the Chinese Communist Party is considerably weaker today than it was before, because they believe that weakness will lead to instability. This point of view inappropriately uses the Maoist period as the basis for comparison by assuming that the level of political control during the Maoist period was “normal.” The reason why the communist regimes in Maoist China and the former Soviet Union needed a repressive control apparatus is that their political and economic practices were fundamentally at odds with human nature. Policies that required family members to betray each other and workers to work for low pay could only be enforced with
coercion and repression.

Repression is only necessary if the government is a repressive one. Compared with the Maoist days, there is no question that most of the government practices and policies today are consistent with the self-interests of the vast majority of the Chinese people. Second, the regime is only passively repressive; it seeks to repress those people who devote themselves to overthrowing the regime, but it leaves alone the social and economic pursuits of most Chinese. Our analysis should no longer focus on the power of the government to constrain people from doing things but focus instead on the incentive or the interest of the people to rebel against or to accept the current government. This is what I mean by the transition from “power politics” to “interest politics.”

The third fundamental of Chinese politics and economics has to do with the relationship between the central and local governments. It is no exaggeration to say that the basic issue of governance facing the Chinese regime is no longer a choice between socialism and capitalism, but a choice between a centralized and decentralized governing structure. After 20 years of trial-and-error, there is now a basic stable framework. In a large, multiethnic, and multi-linguistic country such as China, this framework is a must for maintaining basic economic and political stability.

First, most economic duties reside at the sub-national level and therefore the sub-national level governments command most of the economic and fiscal resources to correspond to the levels of responsibilities. Second, most of the political responsibilities reside at the national level. Political responsibilities include foreign and military affairs, personnel management, and setting forth ideological directions for the country. In addition, the administrative capacity of the central government to carry out some of these responsibilities has been enhanced at the very time when economic decision-making and implementation have become more decentralized. Thus a rudimentary mechanism for political checks-and-balances is already emerging in China. Unlike the United States where political power is shared among three competing but overlapping branches of government, in China the economic resources of the local governments are counter-balanced by the political control of the central government. This is truly a system with “Chinese characteristics.”

**No Catastrophe For China**

During a period of uncertainty, psychology plays a disproportionate and destructive role when it comes to doing business abroad. Investors discount a country’s long-term economic fundamentals because the country is experiencing short-term payment problems even though these short-term payment problems are unrelated to the long-term economic fundamentals.

In this article, I have argued that foreign investors should not be overly influenced by psychological factors. The economic problems in China and in Southeast Asia look deceptively similar but an eruption of a full-blown crisis depends not on the symptoms of the problem but on its causes. Here much of the short-hand analysis in the business press is simply wrong. China does not have an Asian flu and once some of the reform measures of Mr. Zhu Rongji have been implemented, some of the symptoms will be alleviated too.

Politically, China remains a fundamentally stable society. There is no doubt that leaders will continue to disagree about some issues and agree on others and that Chinese society will experience tensions and episodic instability as it is making this difficult transition from a centrally-planned economy to a market economy. However, the relevant issue for the foreign business community is whether these tensions and the policy debate will translate into catastrophic shocks; the answer is a resounding “No.”

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