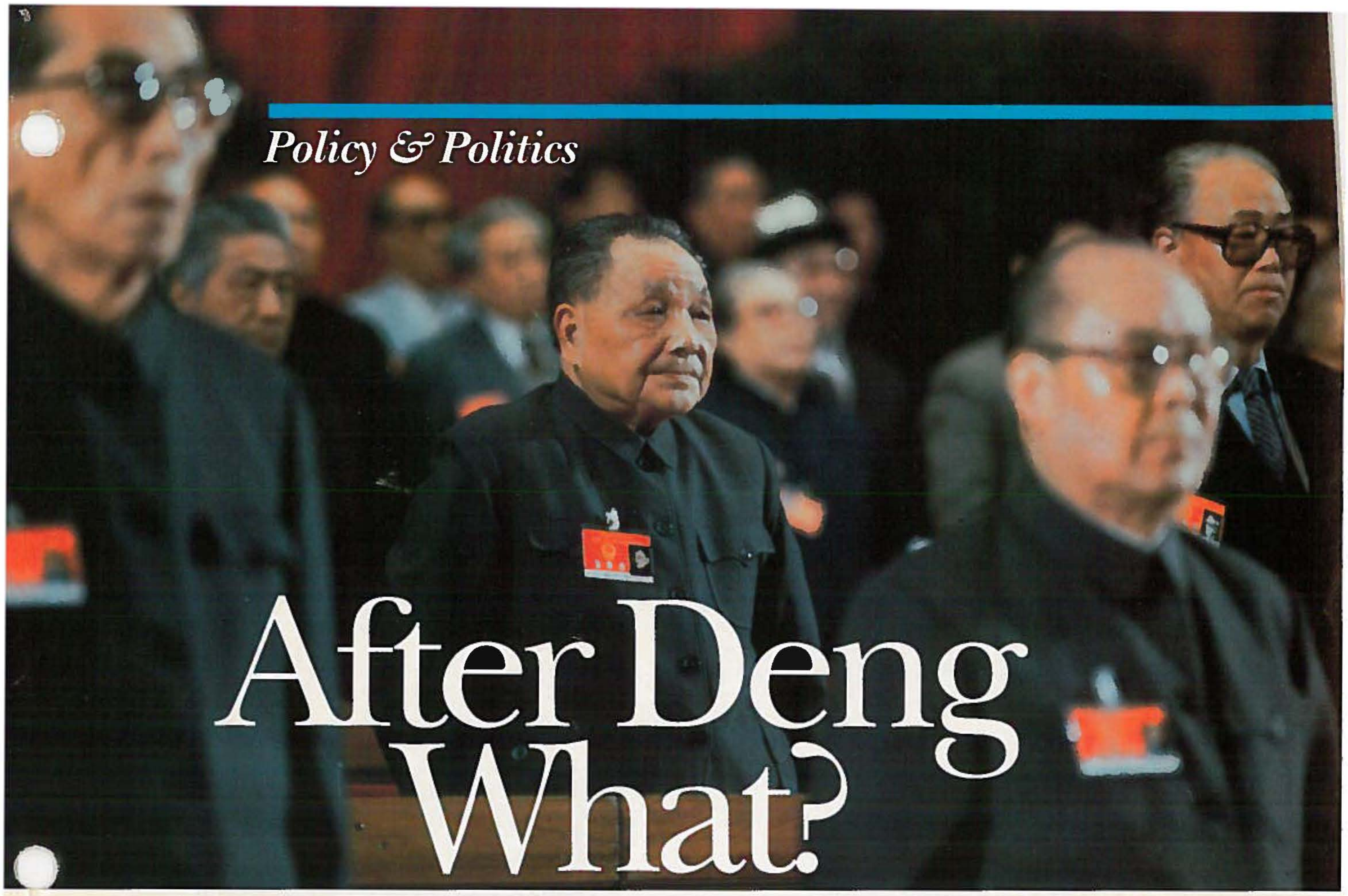


After Deng What?

Three dramatically different scenarios for China's future —and the world's—depend on who wins power in the succession struggle underway

The explosive growth of Southeast Asia including the coastal region of mainland China, has already spurred international business to shift its planning from a traditional focus on the developed economies of North America, Western Europe and Japan to include the vibrant tiger nations of the Pacific Rim.

But the major uncertainty looming over the dawn of the 21st century concerns the future course of giant China—with its huge population, vast natural resources plus rapidly stirring economy—and the outlook for its potential role as a financial, political and cultural superpower.

As Peter Drucker observes about the coming decade: "These will be the most critical years in East Asia since the Mongol invasion. But with any luck, by the year 2005, China may be the world's number two economic power. China is a great question mark."

The most urgent issues complicating forecasts about China's future are what types of political leadership and structure will emerge after the death of Deng Xiaoping. The aged and ailing "paramount" leader was the architect of the quasi-capitalistic reforms which sparked China's current economic renaissance. So far he has managed to keep under control the competing forces that continually threaten the nation's stability. His succession, however, is far from clear.

Further limiting China's ability to maintain its recent pace of growth and sustain its fragile social fabric are a host of other imponderables. These include the unsettling inequities in living standards between the "golden coast" and the impoverished rural interior; strong provincial separatist pressures especially from Tibet; the dearth of the infrastructure, as well as the financial and legal institutions basic to an advanced economy.

Among the most interesting and thought-provoking responses to the question: "After Deng What?" come from Murray Weidenbaum, who headed the Council of Economic Advisers under Ronald Reagan and is now chairman of the Center for the Study of American Business at St. Louis' Washington University. He is co-author, with Samuel Hughes, of the recent book, *The Bamboo Network: How Expatriate Chinese Entrepreneurs Are Creating A New Superpower in Asia.* It describes the role of the overseas Chinese as a driving force behind China's move from communism to capitalism *(Impact 21* will feature a special report on the extraordinary business phenomenon represented by the overseas Chinese in its November issue).

In their final chapter entitled "The Foggy Crystal Ball," the authors note that "straight line extrapolation of China's recent economic success for any long period of time" is not sensible, and offer three provocative alternative scenarios for the future of China, including the differing roles of the "bamboo network" of overseas Chinese therein. As a guide to our readers as they attempt to chart the course of the behemoth nation that will so profoundly affect the world's political and economic fate in the coming years, we present these scenarios.

SCENARIO #1

Successful transition to a market economy

The best future for China—and for those foreigners who invest in it—would be the completion of a successful transition to a market-based, privately run economy. This relatively trouble-free scenario paints China as the next Japan, an economy that in a matter of decades vaulted from Third World status to that of a global leader.

In this scenario, market reforms continue at their recent rapid pace. After Deng's death, the Chinese Communist Party (CCP) economic reformers maintain central government control. Hong Kong is successfully incorporated into the mainland and serves as both model and incentive for future marketization. Macao also achieves its transition with a minimum of turmoil, further facilitating free and open trade within greater China. As fears of expropriation subside, much of the investment that fled these former colonies during the mid-1990s returns to reinvigorate the already booming local economies.

Taiwan also benefits from the increasingly liberal economic environment on the mainland. Even in the absence of outright political unification, closer economic and cultural ties spell an end to the confrontational climate between Taipei and Beijing. Taiwan finds that its enhanced economic relationship with the mainland has convinced the CCP that it would be unwise to use military force to reunite the two. Strong economic and social ties become acceptable substitutes for formal national unity.

As economic reforms move inland, the role of the bamboo network in China's economic development diminishes. As we have seen, most overseas Chinese are originally from the coastal provinces of Guangdong and Fujian. They speak the same language and share the same cultural background as their joint venture partners located in those provinces. As interior regions attract foreign investment, however, these advantages diminish. Tight, family-run organizations find it increasingly difficult to cope with a national Chinese market.

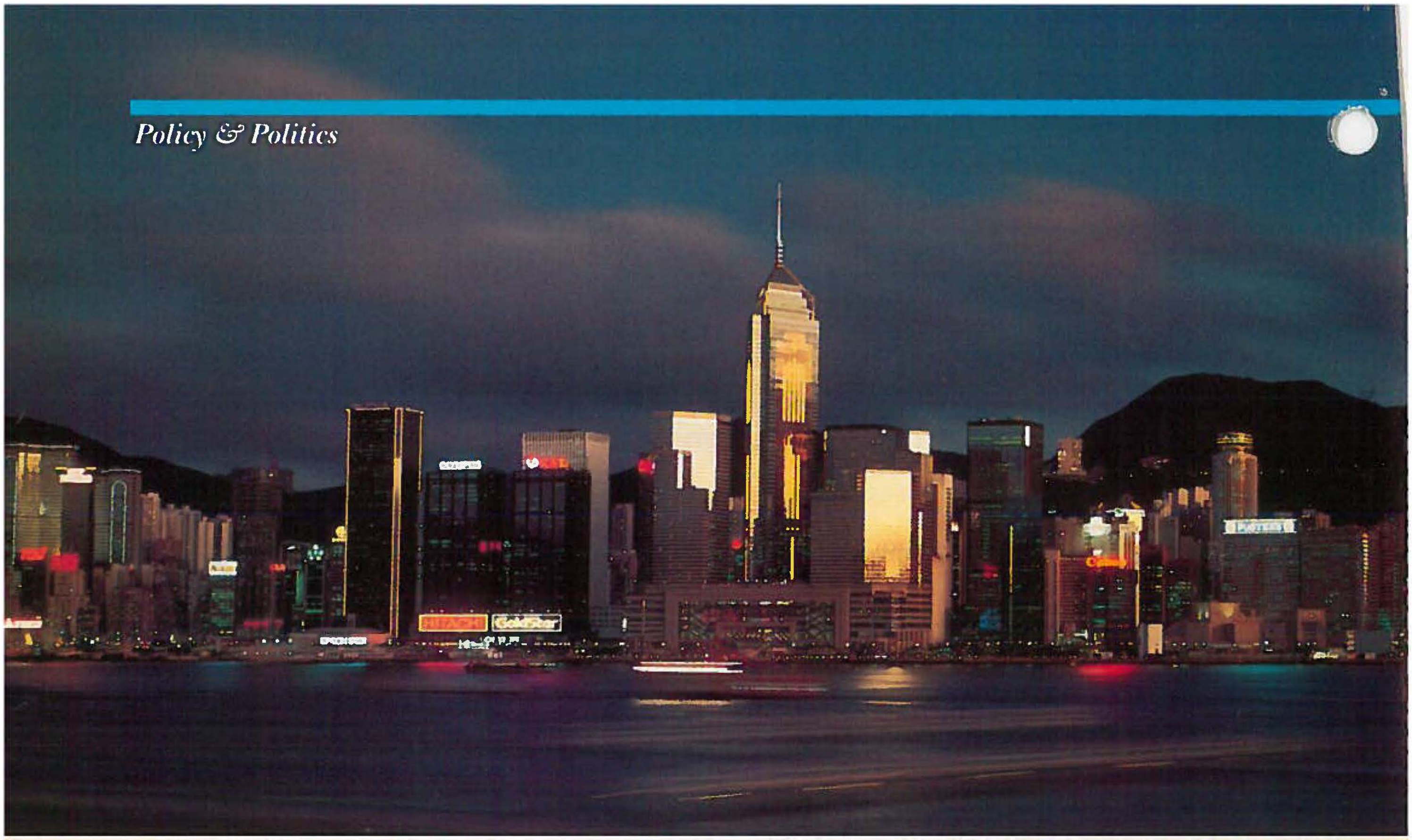
While still maintaining a strong presence, the bamboo network ceases to be the principal driving force behind commerce and entrepreneurship. As concerns over political stability ease, large Western, Japanese and Korean multinational firms—often with a higher level of technological sophistication—develop a strong manufacturing presence on the mainland. Responding to this, the management structures and ownership of ethnic Chinese firms modernize in order to compete on a worldwide playing field. Efficient capital markets eliminate many of the advantages of privately financed family businesses. Publicly held firms that can raise capital through modern investment channels emerge as more efficient alternatives to the family dynasties that utilize enormous private financial reservoirs. Stock and bond offerings become more commonplace as the government continues to lift restrictions on stock exchanges and financial markets. Investors in China show a strong interest in maintaining the momentum of both political and economic reform.

"Straight line extrapolation of China's recent economic success for any long period of time" is not sensible...

Prosperity and political reform

Greater wealth and prosperity—as was the case in Taiwan and South Korea—lead to political reform. Tentative steps toward democracy help ease internal pressures and boost China's world standing, particularly with the United States, which rewards China with permanent most-favored-nation status. Early in the 21st century, China gains membership in major international trade and financial organizations and in economic alliances. In the longer run, sustained economic development produces dramatic gains in the standard of living. Per capita income rises to levels equal to those of other Asian dragons such as South Korea.

This optimistic scenario is not realized automatically or easily. In order to fully evolve into a market



If China succeeds in becoming a market economy, Hong Kong would lose out to Shanghai, Guangzhou and Beijing.

economy, China continues to decontrol prices and markets aggressively. Government tinkering with market mechanisms to achieve political or social goals is abandoned. The military cooperates with the new leadership because it sees direct advantages in doing so. The People's Liberation Army's (PLA's) numerous business enterprises, including joint ventures with foreign investors, benefit greatly from the general economic expansion. The revenues from these civilian businesses provide the PLA with substantial budgetary independence from the civilian government authorities. This independence, coupled with continued modernization, helps to transform the PLA into a more professional, politically neutral organization.

Inflation controlled

High inflation initially threatens to undermine China's economic prospects. Investors worry that the transition from explosive growth to a mature rate of economic development will burst the bubble of optimistic expectations that drives so much of the entrepreneurial energy in China. Nevertheless, the government manages to control inflation sensibly, simultaneously achieving a modest short-term slowdown in economic growth and a limited rise in unemployment. It does so by adopting Western-style monetary and fiscal policies and by phasing out subsidies to government enterprises.

State-owned firms that cannot stop the flow of red ink on their own are forced to go bankrupt. This tough action frees up capital and skilled labor for more profitable enterprises in both the public and the private sectors, especially in the expanding town and village enterprises. To help ease the plight of laid-off workers, Beijing establishes a safety net in the form of a limited social security and welfare system.

Free markets and sound monetary policy are not enough to ensure economic prosperity, however. China also finds it necessary to fully develop its economic infrastructure in order to complete its market transition. Within the next decades, key ingredients of a modern capitalist economy emerge: a body of commercial law, secure property rights, reliable accounting systems, a viable insurance industry and a competent judiciary. These advances are accompanied by significant liberalization in foreign trade policy. Tariffs are reduced and quotas are phased out in accordance with international agreements.

Free trade flourishes

Free and open trade between Taiwan and the mainland proves beneficial to both parties, saving them the expense of masking transactions by re-exporting through intermediaries (indeed, the incorporation of Hong Kong into China eliminates that "back door"). The increased mobility of capital and labor allows for the full exploitation of regional specializations. Free trade agreements, as well as technological advances in transport and telecommunications, undermine remaining barriers to trade. Owing also to the common language and culture of China and Taiwan, a level of commercial activity is generated surpassing that of the United States, Canada and Mexico under the North America Free Trade Agreement.

A chopstick union

In the long run, Hong Kong loses some of its privileged position as *entrepôt* to China. High real estate and labor costs in Hong Kong force more and more firms to locate directly on the mainland. The economic center of China shifts north and east as Guangzhou, Shanghai and Beijing assume portions of the trade and financial activity formerly centered in Hong Kong. Following this shift, a free trade zone compromising Japan, Korea and China—a "chopstick union" as overseas Chinese magnate Robert Kuok terms it—could link the region's three largest economies.

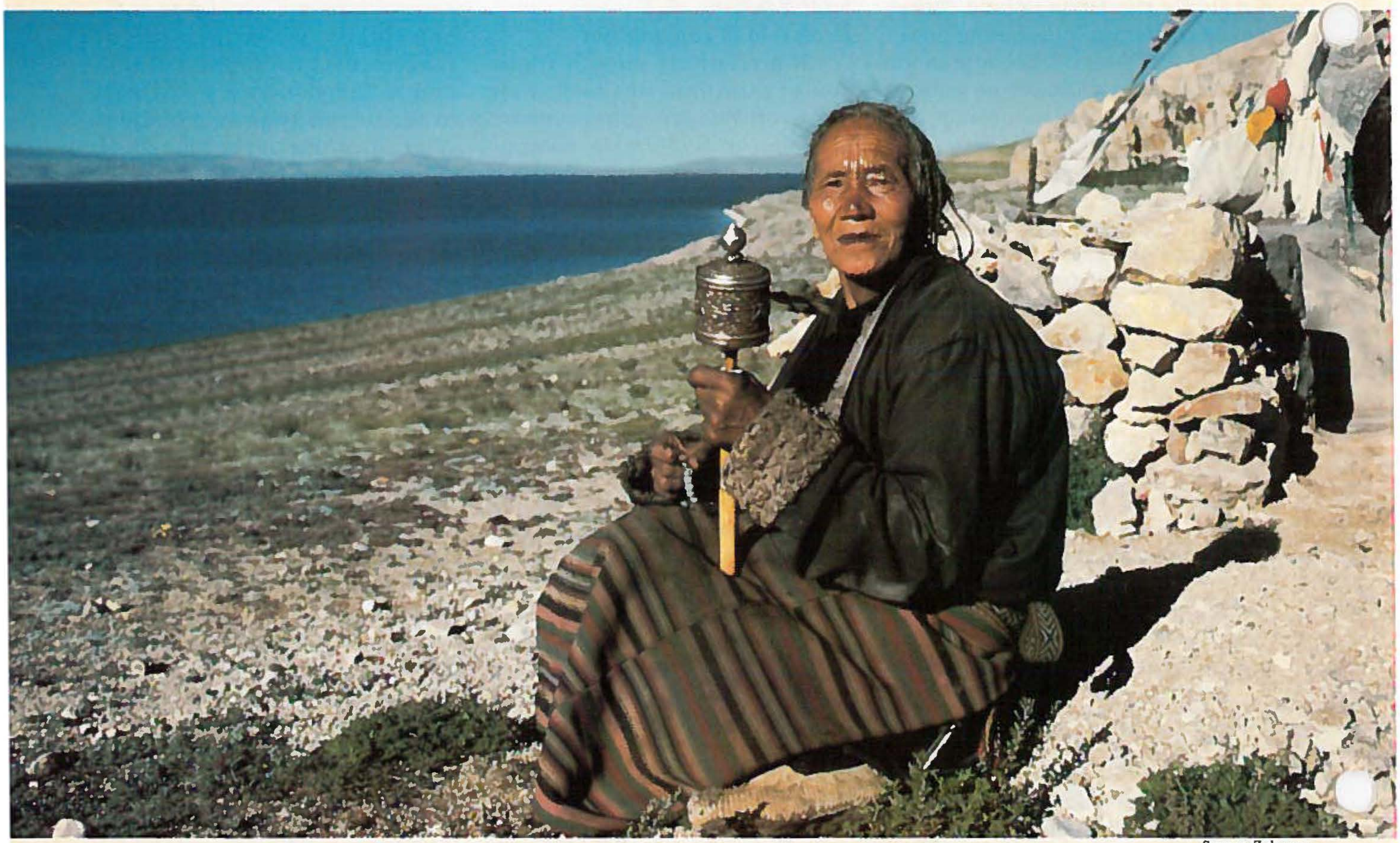
A unified, market-driven Greater China forces massive global shifts in the geographic distribution of investment, trade, production and employment. The earlier rise of nations such as the United States and Japan is illustrative. Their admission to the club of developed nations had powerful military, political and economic repercussions. Their success signaled an end to European domination of the globe, economically as well as politically and militarily. The resulting expansion of world trade, investment and production brought about absolute gains for each of the world's industrialized economies, although some of the older economies experienced a declining *share* of the world market.

The graph on page 36 forecasts the economies of the United States, Japan and China on the basis of this scenario. China (unified with Hong Kong) catches up to Japan in the year 2004 and then sprints ahead to rival the United States by the year 2019. These dramatic conclusions are based on several key assumptions:

Assumptions behind China as #1

1. China's economy grows at the rate of 8 percent a year. This is substantially lower than its recent double-digit pace, which is probably not sustainable. The 8 percent figure is equal to the actual growth rates of other Asian dragons—Thailand, Hong Kong, Singapore and South Korea—over the last 25 years.

2. U.S. growth is 2.6 percent a year while Japan's is 3.8 percent a year. The U.S. figure is the average of the long-range predictions of two well-known forecasters: Oxford Economic Forecasting and Laurence H. Meyer & Associates. The Japanese projection is consis-



Sonam Zoksang

If China becomes fragmented, Tibet would join Xinjiang and northeast Manchuria to form its own empire.

Growth Scenario Showing China Catching Up

GDP (PPP basis) in billions of dollars

tent with its experience over the past 25 years.

3. We use the World Bank estimates of the Japanese and American economies (purchasing power parity (PPP) basis). Because of the considerable difficulty in estimating China's GDP, we average the World Bank's PPP estimate with the much lower, conventional GDP measure based on international exchange rates. The result is a conservative estimate of China's GDP on a purchasing power parity basis.

Although the timing of the two crossovers is roughly estimated, it is clear that China is gaining on the two economic superpowers. Undoubtedly, it is earning a position as one of the new Big Three. According to this scenario, it is only a matter of time before China moves into second place—and quite possibly into first.

The impact on the rest of the world will be profound. The presence of four superpowers—China, Western Europe, the United States and Japan—lends itself to shifting alliances and renewed rivalries. Any balance of world power that is achieved is likely to be unstable and short-lived. In such circumstances, the most powerful competition likely will be economic and technological—although political and military rivalries will remain.

SCENARIO #2

Reversion to communism

If a relatively smooth transition to capitalism in China is the dream off Western entrepreneurs, reversion to totalitarian communism is the nightmare. Parallels with the former Soviet Union abound. Widespread crime, ethnic violence and ultranationlism are the by-products of Russia's drastic reforms, and threaten a return to communism or another form of totalitarianism. Today's China faces similar problems accompanying its rapid economic change (although so far they seem to be less virulent).

The hard fact is that China remains a communist nation. Despite the economic transformation along the coast, a relatively small number of Communist party members—52 million, or only 4 percent of the population—continues to exercise a monopoly over political control. Thus, they retain ultimate authority over economic policies and practices, even when this power is not overtly exercised. Through its massive system of official posts and bureaucratic agencies, most of which are filled by party members, the CCP controls regulatory and legal decision making. It also controls the PLA, although this relationship is more tentative: Beijing understands that the same troops that keep it in power, can also if threatened, *remove* it from power.

Some CCP members sincerely believe in the communist ideology and are bitter about the economic changes that have occurred since 1978. Many more, however, see party membership simply as a way of developing *guanxi* [connections]. CCP connections enable firms to receive preferential treatment from government regulators and inspectors who, in turn, expect rewards for their displays of favoritism. In a country where the bureaucratic allocation of labor, capital, energy and business permits is widespread and arbitrary, CCP connections are crucial to many enterprises. Ironically, such arrangements give individual communist functionaries a vital stake in the success of private business. After all, profits can be shared only if they are generated in the first place.

Army backs hard-liners

In this scenario, continuing economic progress threatens to reduce the traditional power base of the CCP. Within the rural areas, the demise of communal enterprises has already reduced the influence and authority of party officials. After Deng's death, a powerful hard-line faction emerges as young CCP conservatives—many the children of senior, aging hardliners—push to end reform. These princelings seek to retain centralized economic control and prevent the development of a middle class that could challenge CCP authority. Deng's death is the pivotal event that spurs a power struggle between the hard-line coalition and economic reformers.

The role of the PLA in the ensuring conflict turns out to be crucial. Both factions struggle to retain control over the PLA, and both fear that the military's power is so great that it will resist, or even ignore, their orders. In this scenario, the PLA exhibits a high degree of loyalty to CCP hard-liners, as it did in June 1989 when its conservative allegiance was reaffirmed.

Disaffected workers

Popular support for changing China's economic policy comes, as it did in 1949, from the rural inland provinces. Since 1978, a large disaffected class has emerged in the form of vast numbers of uneducated agricultural laborers who are not needed in a more efficient agricultural sector. Many of them fill the ranks of the *mang lui*—disillusioned migrant workers who are particularly anxious for a return to communism. Even when employed, they are angered by the large and growing income differential between skilled urban workers and rural laborers. Ironically, farmers who were at the forefront of economic reform in the early 1980s now find themselves at the vanguard of a communist reversion.

With the firm support of the PLA and rural peasants, the hardliners assume power. Yang Shangkun, former president of the CCP, succeeds Deng on the basis of his close personal ties with the senior leadership of the PLA. Yang, an octogenarian, occupies the leadership for a short period of time. After his death, younger conservatives seize power. An ideologically unified group of top officials selects a new paramount leader (perhaps Li Xiaoyong, son of Li Peng). Together, the members of this conservative alliance guide China away from what they view as the corruption of Mao's vision under Deng and the pragmatist factions of the party. The unified senior leadership halts and then reverses market reform.

Within a decade, China returns to the practice as well as the theory of Marxism-Leninism. The state reassumes control of industry and allows only limited agricultural privatization in staple crops. Expansion of the Special Economic Zones ceases and many of the privileges of the existing zones are gradually withdrawn. Because these regions supply necessary foreign currency to the central government, as well as profits to CCP officials, some unofficial openness continues to be tolerated. This is especially true in Shanghai, where loyalty to the CCP was maintained throughout the period of capitalist reform.

Massive capital flight

This rapid reversal of economic policy scares many foreign investors into moving their mobile investments elsewhere. Massive capital flight ensues as overseas Chinese and other foreigners seek to remove their funds from China before widespread nationalization occurs. These efforts, in turn, force the Chinese government to severely restrict outflows of money, material and people. Economic growth halts. The country is plunged into deep recession. Living standards plummet as enterprises cut their production and investments lose their value.

One winner in this scenario is

The People's Liberation Army and rural peasants would be supporters of China's reversion to communism.

Paul Lau/Liaison

the PLA. Strong central control over regional authorities requires a well-funded military. Senior CCP members with close ties to the PLA push for the continued modernization and expansion of China's armed forces. Military power lends itself to use. Thus, in its desire to remain energy-independent, Beijing mounts a military campaign to seize disputed oil reserves in the South China Sea. In the worst-case scenario, the burgeoning independence movement in Taiwan prompts an invasion by the mainland.

The central authorities still recognize the importance of Hong Kong as *entrepôt*, financial center and supplier of foreign capital for critical projects. This limits the squeeze they can put on that territory. Furthermore, the realities of the information age make it difficult for the communist government to fully insulate the mainland from Hong Kong and Taiwan, especially from the latter's liberal economic policies. Nevertheless, nervous investors pull out large amounts of their funds, causing a rapid deflation of property values in once-booming Hong Kong and Shenzhen. Those who remain are straddled with heavy debt.

For Taiwan, risk and reward

Taiwan's already delicate political position worsens after China's drastic shift leftward, making it impossible for the island to conduct more than a limited, black market trade with the mainland. Aggressive moves by CCP hard-liners heighten fears that Beijing will seek to settle its claim over Taiwan with military force. As a hedge against such threats, Taiwan distances itself from the mainland politically and economically. Its own economy enjoys an influx of capital from investors retreating from China (which now includes Hong Kong).

As we have seen, many of the advantages of the bamboo network are based on the trust that obviates the need for formal contracts. This works well only in an environment where people have the power to keep their promises. But in a totalitarian state, layers of bureaucratic authority undermine the discretion of most people in society. Thus, the commitments they make are less reliable. Operating costs are increased substantially by the need to negotiate a labyrinth of entanglements and a morass of official channels.

After China's open door is slammed shut, the established networks of overseas Chinese investors therefore have an increased incentive to exploit the trading opportunities present in other parts of Southeast Asia. New "growth triangles" emerge to replace the trade between Hong Kong, Taiwan and China. Due to their geographical proximity, portions of Thailand, Indonesia, Vietnam and Malaysia become segments of these triangles. Each of these nations has experienced rapid growth over the last decades and has established, large-scale enterprises financed by overseas Chinese. Singapore, with its large and wealthy ethnic Chinese population, replaces Hong Kong as the region's dominant center of finance, investment and trade for overseas Chinese business interests.

However, none of these new trading regions possesses the dynamism and potential of Greater China (the mainland, Hong Kong and Taiwan). They are limited by much smaller labor forces and fewer opportunities for their entrepreneurs to utilize their financial reserves and know-how. Of greater importance, they lack the cultural homogeneity of Greater China. Differences in language, religion and ethnic background are too great to permit the easy business relationships that were the norm on the mainland. The impressive complementary nature of economic and natural resources of Singapore, Malaysia and Indonesia is offset by fundamental differences in language (e.g., Malay versus Chinese), culture (Chinese versus Hindu), and religion (Moslem and animist versus Buddhist). The economic expansion and new wealth that are generated in these growth triangles exacerbate the existing tensions between overseas Chinese and the native majorities. For all these reasons, the remarkable successes that occurred along the China coast are not repeated elsewhere in Southeast Asia.

World's economic status quo

Reversion to communist economic policies does not generate a new economic power in China or Southeast Asia comparable to the United States, Japan or Western Europe. The status quo in the world economy is maintained. Some of the investment capital currently in the region shifts to Latin America and other developing parts of the world.

India (see page 18), in particular, has the opportunity to serve as a substitute for the mainland. Relying on its unique combination of large population, an established legal system and a substantial professional class educated in English and modern managerial methods, India tries to become a major factor in the world economy. This effort meets with some success but is limited by the country's massive entrenched bureaucracy, which inhibits entrepreneurship and innovation.

SCENARIO #3

Growing instability leading to fragmentation

Despite the statistics that show strong aggregate growth, economic development has been far from uniform throughout China. As we have seen, tremendous disparities exist between the inland provinces and the so-called Golden Coast. Part of this difference can be explained by the coastal region's geographical and cultural proximity to overseas Chinese investors. This natural advantage is augmented by tax policies and special incentives to foreign investment that are not present in the interior and western provinces. Provincial disparities are heightened further by the wide-scale transfer of power from the central government to local and regional authorities that has occurred under Deng.

In this scenario, two distinct regions, or "empires," emerge within China as a result of social pressure generated by increasing economic inequality. The "outer empire" comes to include Tibet, Xinjiang and northeastern Manchuria. Each of these areas has sharp language, cultural, religious and ethnic differences from the more homogenous "inner empire," which includes China's southern and eastern coastline and is populated primarily by Han Chinese.

Deng's demise is followed by events similar to those in Yugoslavia following the death of Tito. Political infighting within the CCP prevents the ruling handful of Deng protégés from making the transition to a strong central authority. Leadership by a committee turns out to be unstable. As a result, there is no single authority that can keep at bay the forces tearing China apart. External pressures, coupled with the centrifugal pull of China's periphery, cause the two fragile empires to fragment.

Separatist pressures too strong

Western China in particular poses separatist challenges beyond the capability of the post-Deng government to manage. The region's strong religious, historical and language ties to bordering Russia, Pakistan and India provide powerful incentives for political independence. Within this region, Tibet is the first to attempt separation from Beijing. Rebellion in Tibet creates sparks in other regions, with the independence movement in Xinjiang Province flaring into an armed uprising.

Encouraged by these rebellions and aware that the PLA cannot be everywhere at once, the southeastern coastal provinces declare their autonomy. Centered in Guangdong and Fujian Provinces, separatists resent sharing their wealth with Beijing and the poorer provinces. As justification for their action, they point to their historical ties with areas outside the mainland. Over 80 percent of Taiwan's population are descendants of emigrants from Fujian, and most Taiwanese speak the Fukienese dialect prevailing in Fujian. Likewise, Hong Kong's citizens speak mainly Cantonese—the dialect of nearby Guangdong. These language and cultural links reinforce the economic chasm that separates the coastal provinces from the rest of China.

The dissolution of China into region states, bound together in a commonwealth, could create a dynamic new trading region.

Guangdong is in an especially strong position to break away from Beijing. For many years, it has been receiving only a small fraction of its capital investment from the central government. Instead, it has been financing its own development primarily by attracting investment from overseas Chinese in (or through) nearby Hong Kong.

In this scenario, the PLA is unable to put down the simultaneous rebellions throughout the country. Although Tibet's independence can be tolerated, Xinjiang's vital oil resources demand protection. Likewise, the economic wealth of the coastal regions—and the tax revenue they supply—are critical to Beijing. Nevertheless, the PLA faces stiff opposition from armed rebels and internal police units. It also encounters rebellion within its own units, some of which defect to the provinces in which they are based.

International crisis

Disturbingly, some of these regional forces control nuclear weapons, elevating the situation to an international crisis. The conflicting voices emanating from Beijing do not help matters. The lack of a strong consensus prevents an effective response to the rapidly deteriorating situation. In the resulting chaos, the western provinces succeed in permanently breaking off from China, while an uneasy compromise is achieved among Beijing, Shanghai and the coastal regions. Taiwan achieves total independence and its sovereignty is recognized by many foreign nations.

The United States, Russia and Japan follow the developments closely. Without saying so publicly, they are relieved that China is no longer an effective rival. Concerned over the possibility of a protracted civil war such as Yugoslavia's the Big Three succeed in brokering a series of limited peace agreements.

In the longer run, the dissolution of China into region states, possibly bound together in a Commonwealth of China, could create a dynamic new trading region. Unconstrained by cautious central authorities, regions could experiment with even more dramatic economic and political reforms, compete for foreign investment capital and specialize to exploit comparative productive advantages. But that is a possibility for much later in the 21st century. ■

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