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What Could Go Wrong?

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What Could Go Wrong?

China has done remarkably well in its development over the last twenty-five years. It has achieved and sustained high rates of economic growth, lifting millions out of poverty. It has achieved a significant place in the international economy. It is widely regarded as a major power, not only in Asia but also increasingly on a global stage. Looking ahead, however, things could go wrong – possibly quite seriously wrong – for China, and if China experiences serious problems, its size and its expanded role in the world mean that there could be serious consequences for the broader international community as well.

This brief paper will consider four possible types of crisis in China: economic, humanitarian, international and political. Although these crises will be discussed separately, in fact one kind of crisis could easily trigger another. For example, a humanitarian crisis could trigger an economic crisis, and an economic crisis could spark a political crisis. (The interrelationships among these potential crises will be discussed in the conclusion.) In that sense, all the crises have, at least potentially, economic consequences.

The basic model used in this paper is the one that is used at Eurasia Group to assess political risk: the risk of a crisis is a function of a country's vulnerability and the likelihood of shock. That is, how serious are a country's problems, relative to the mechanisms that it has created for dealing with those issues? (The term "stability" or "vulnerability" will be used for this.) And then, what is the likelihood that some development will trigger a crisis? (The term "shock" will be used for this.)

Both variables are important, since both are necessary and neither is sufficient: An unstable country may avoid a crisis simply because it is fortunate enough not to experience a shock. Conversely, a shock that could trigger a crisis in an unstable country might be rather easily absorbed in a more stable society.

Economic Crisis

Economic crises fall into two general categories: crises of inflation and crises of recession. Inflationary crises are manifest in dramatic increases in prices, particularly for consumer goods. Crises of recession may involve decreases in prices, but also entail a slowing of economic growth, increases in bankruptcies, and surges in unemployment. If they are sufficiently severe, they can become outright depressions.

China today is already vulnerable to significant deflationary pressures, largely from overcapacity in many parts of the economy, particularly some raw materials (such as steel),

manufactured goods (such as automobiles), and real estate (particularly in major coastal cities such as Shanghai and Beijing). These pressures could be exacerbated by internal or external shocks to the Chinese economy. Of particular importance would be:

- A downturn in the global economy, which would reduce Chinese exports and incoming foreign direct investment;

- A disruption in domestic economic activity in China, which might be produced by an epidemic of communicable disease, by a major natural disaster, or by a significant environmental incident;

- A significant upward change in the value of the renminbi, which would reduce demand for Chinese exports and reduce the attractiveness of foreign direct investment in China.

While these recessionary pressures are real, and the possibility of these shocks cannot be excluded, the Chinese government has both the incentive and the ability to respond to them. Beijing has a strong interest in avoiding recession because of its concerns with the political consequences of unemployment. Therefore, Chinese leaders would almost certainly try to respond vigorously to moderate any economic downturn. And they have several instruments at their disposal: loosening policy on bank credit, increasing government spending (even at the cost of increasing government indebtedness), and devaluing the renminbi. To be sure, Beijing may find it harder to pump bank loans into the economy as foreign investors gain greater control over the lending policies of Chinese banks, but overall Beijing's ability to conduct stimulatory policies remains impressive.

As a result, the shock would have to be significant in order to overwhelm these adjustment mechanisms. It would have to entail a wide-scale collapse of international trade, perhaps because of a terrorist incident that targeted international commerce, rather than simply a recession in one of China's major trading partners. Or it would have to involve a pandemic in China, rather than a localized environmental incident. Or several shocks, internal and external, would have to occur simultaneously. Otherwise, China increasingly has the wherewithal to stimulate the economy to overcome more moderate deflationary pressures.

Conversely, China is also subject to a number of inflationary pressures. These include the rising cost of imported energy and raw materials; increasing demands on government to increase spending to deal with various social and environmental problems; growing consumer demand, especially in prosperous urban areas, but potentially in poorer areas as well; and above all chronic tendencies toward inefficient investment, largely the result of lax controls on bank credit.

These inflationary pressures could cumulate gradually, or they could be exacerbated by a poorly designed or poorly implemented policy response to a deflationary trend. The most obvious danger would be a run on one or more banks, which the Chinese government addresses by increasing liquidity. However, as China reforms the largest state banks, the risk of a large-scale banking crisis gradually recedes. There remains the possibility of runs on smaller local banks, but the consequences of a local banking crisis are easier to manage.

Moreover, the Chinese government has the ability and experience to take remedial measures. It can reduce investment by administrative means; it can raise interest rates; it can control the money supply; and it can repress increases in liquidity by increasing its sales of government bonds. And, as noted above, there are powerful deflationary pressures in the Chinese economy that in themselves would limit the impact of inflationary forces.

Thus, it seems that the probability of either significant inflation or significant recession is relatively low. China may well experience a business cycle, as is normal in all economies, but it increasingly has the capability to moderate that cycle through a combination of fiscal policy, monetary policy, and administrative decision. The shock would have to be extremely large to overwhelm China's adjustment mechanisms.

For the international community, an inflationary crisis would make Chinese exports more expensive. That might spread inflation from China to other countries, unless Beijing depreciated the renminbi to moderate the increase in export prices, or unless other cheaper imports from other countries could begin to substitute for dearer imports from China. However, the greater international risks would come from a recession in China, since that would significantly reduce China's ability to serve as an engine of growth for its trading partners.

Humanitarian Crisis

Humanitarian crisis means a significant and acute challenge to human security in China. This is a far greater risk than a purely economic crisis, since there are many potential causes that are largely outside the ability of government to prevent, and many possible consequences that could overwhelm the government's ability to cope.

Historically, the greatest humanitarian crises in China have been the results of natural disaster. Floods and earthquakes have killed millions over the centuries. Southeastern China is also vulnerable to tropical storms, particularly along the coast. These kinds of natural disasters could recur at any time – with the severity of tropical storms possibly increased as the result of global warming, and the possibility of flood now reduced at least marginally by China's aggressive policy of dam construction for water conservancy and power generation purposes. (However, the risk of a flood being caused by the collapse of a large dam has now been increased.)

China's ability to respond to crises of these kinds is greater than many other developing societies, because of the availability of large numbers of armed forces to conduct domestic relief operations. On the other hand, the growing urbanization of China, and the degree to which complex urban societies are more vulnerable to disruption, may increase the costs of certain kinds of natural disaster, particularly earthquakes.

China is also vulnerable to another form of humanitarian crisis familiar throughout human history: a pandemic produced by communicable disease. China is at risk from the spread of HIV/AIDS, a chronic debilitating disease that can not only impose burdens on the public

health system, but can ultimately have broader economic implications if there is a significant reduction in the productivity or even the numbers of workers. Acute disease is an even greater risk, particularly diseases such as SARS and avian flu. China is natural breeding grounds for many such diseases, primarily because in many parts of the country humans and animals live in close proximity. The rapid spread of a disease with a high mortality rate can have devastating consequences for public health, economic activity, and social stability.

In coping with the spread of acute disease, the Chinese government again has the advantage of a high level of political organization and coercive power, which makes it more feasible for the government to quarantine affected areas. However, it also has the disadvantages of inadequate monitoring and reporting mechanisms (which increase the risks that the disease will emerge and spread before it can be identified), and inadequate public health facilities, especially in the countryside (which increase the mortality rate of diseases that could otherwise be treated or prevented). China would probably be able to cope with mild outbreak of communicable disease, but a more serious pandemic of avian flu could easily overwhelm China's coping mechanisms, just as it would overwhelm the ability of most governments to respond.

It remains to be seen whether China will be able to deal effectively with the spread of HIV/AIDS. It is devoting more resources to the task, and seems to have made progress in reducing the transmission of the disease through the sale of tainted blood, but the disease now appears to be spreading through the more customary routes of the exchange of needles by drug users and unprotected sex, especially with sex workers. Here, the loosening of political controls over society will make the problem more difficult to address.

Finally, China is experiencing increasingly serious environmental risks. Again, these can be either chronic or acute. Chronic problems include high levels of air and water pollution and the inadequate availability of potable water or even water that can be used for agricultural and industrial uses. Acute problems can be produced by industrial accidents that cause sudden discharge of pollutants, such as the recent benzene spill in Jilin, or a prospective Chernobyl-type discharge from a nuclear power plant. As Beijing's international visibility increases, or as internal minority problems increase, one cannot rule out the possibility that domestic or foreign terrorists would use nuclear or radiological weapons against China.

The complexity of some environmental problems increases the likelihood that some of them may be so severe as to overwhelm a society's coping mechanisms. Acute humanitarian problems can force termination or suspension of economic activities, disrupt normal social life, and force relocation of large numbers of citizens. Chronic problems – like chronic disease – can reduce economic productivity and place a significant strain on a country's public health system.

In short, other things being equal, China probably has the ability to cope with mild environmental issues: most natural disasters, mild outbreaks of disease, and localized environmental problems. It would have difficulty in dealing with more serious humanitarian crises. This is true not only because of the scale and intractability of some of these problems, but also (as the recent benzene spill in Jilin demonstrated) because of the relatively poor ability of the Chinese political system to deal quickly and transparently with this kind of acute crisis.

These issues of humanitarian insecurity can also have significant international consequences. Environmental pollution can spill across international boundaries, as we have seen with water pollution in Northeast China and air pollution near Hong Kong. If people relocate to avoid environmental degradation, they may seek refuge in neighboring countries. If they disrupt normal economic activity, they can also have major implications for the global economy.

International Crises

China could experience two kinds of international crisis: those that it initiates, and those in which Beijing responds to what it regards as intolerable provocation. Not all of these crises would necessarily take a military form. They could produce a diplomatic crisis, or the imposition of economic sanctions, instead of (or prior to) military action.

At present, the second type of crisis is of greater concern, since Chinese leaders seem to seek a peaceful environment so that they can focus on domestic problems. What kind of external trigger might create a situation in which Chinese leaders, despite a preference for stable international relations, felt they had to respond to provocation?

- Declaration of *de jure* independence by Taiwan – or an action that Beijing regards as an unacceptable step in that direction. (The greatest danger here – although still relatively low probability – is that a Taiwanese president may feel that there is a window of opportunity before or during the Olympic games of 2008 to declare independence.)

- The construction of facilities, or the exploration or extraction of natural resources, in disputed territorial waters. (Of most immediate concern is the East China Sea, where Japan may begin to drill in underwater resources claimed by China, but there are similar risks in the South China Sea as well.)

- The collapse of the DPRK, whether for internal or external reasons, followed by foreign intervention in northern Korea without adequate consultation with China. (The collapse of other neighboring countries, although less likely, could pose similar risks.)

- Transnational border problems (especially terrorist attacks or other forms of criminal activity) that produce a forceful Chinese response. (Of particular concern would be those that suggest links to ethnic minorities inside China.)

- Chinese military action to protect nationals or investments overseas. (This is of growing concern as Chinese firms "go global", especially in unstable areas.)

- An incident between Chinese military forces and those of another country, particularly during a period of tension for other reasons. (The obvious precedent is the EP-3 incident of 2001.)

- The perception that the United States was attempting not simply to counterbalance China, or hedge against its rise, but more actively to contain China (by undermining its relations with other countries) or to subvert it (by supporting forces aimed at overthrowing the Chinese government).

As noted above, Chinese leaders want a peaceful environment – as do virtually all of its neighbors. Moreover, there are numerous avenues for bilateral and multilateral consultation on many if not all of these issues, most of which are already the subject of substantial international dialogue. This increases the chances that these crises either could be avoided, or could be successfully managed or mediated without degenerating into open conflict.

However, it is the exceptions to this favorable pattern that are worrying. These include the absence of any official dialogue between Taiwan and China, and the suspension of high-level dialogue between China and Japan. Other issues, such as protecting nationals or investments overseas, are relatively new for China, thus increasing the possibility of miscalculation, but possibly also generating greater caution on Beijing's part.

Of particular concern is the emotional character of some of these issues, especially those that involve territorial disputes (Taiwan, East China Sea, South China Sea) or bilateral relations that are especially sensitive in China (Taiwan, Japan, the United States). There is the danger that rising Chinese popular nationalism could significantly reduce Beijing's room for maneuver. There is also some question as to whether China's civilian leaders could completely control the response of the Chinese military to a crisis involving the military forces of other countries.

Over time, the possibility that China would initiate a crisis itself increases. In its most serious form, this would entail an unprovoked attempt to assert China's interests (either long-standing interests or newly-identified interests) by military action. (Of course, Beijing might try to generate a pretext for its actions, but ultimately objective observers would regard Chinese initiatives as unprovoked.) China could also create a crisis through means other than force, particularly through the use of vigorous diplomatic pressure or economic levers. Examples include:

- The use of military force to consolidate control over disputed territory, at land or at sea (South China Sea, East China Sea, Diaoyutai islands).

- The use of force or economic pressure to compel Taiwan to enter negotiations on unification (most likely to the grounds that it had shown a "protracted refusal to negotiate").

- Intervention in neighboring countries (Laos, Burma, Mongolia, North Korea) to protect or install friendly governments.

- Resurrection of historical territorial claims that had previously been set aside (particularly to Mongolia and parts of Siberia, but also conceivably to northeast India).

- Pressure on the allies of the United States to attenuate their security relations with the United States.

- The use of economic or diplomatic pressure to bring other governments under greater Chinese influence (the equivalent of the Russian pressure on some of the former Soviet states).

- Chinese attempts, directly or indirectly, to undermine existing international norms and organizations, or to create new international regimes more favorable to Chinese interests.

A more assertive and provocative China would reflect what might be called (following Peter Gries) the emergence of "malign nationalism" in that country. That, in turn, might be the result of a weak government in Beijing responding to popular pressure from below, an insecure government seeking to restore its flagging legitimacy by generating a crisis that would mobilize nationalistic fervor, or a more confident government feeling that the balance of power had shifted in China's favor, and that it could therefore define its national interests in a more ambitious way.

These crises have the most obvious implications for the international system: they involve the prospects for diplomatic rivalry, economic sanctions, arms races, or even open military conflict between China and other states. Even in the absence of official economic sanctions, international crises can have economic consequences if they lead foreign consumers to boycott imported goods, or lead foreign businesses to a heightened concern about the political risks of investing in a certain country.

Political crises

Chinese leaders themselves are the first to admit that their country faces a number of serious problems that could have political consequences. The most serious of these include growing inequalities between rich and poor regions, and between rich and poor families within regions; pervasive corruption and malfeasance on the part of government officials; severe environmental degradation; expropriation of land by local authorities, often without adequate compensation; the decay of the educational and public health systems, especially in rural areas; a continued need to find productive employment for new entrants into the labor force and for the underemployed in rural areas; the fragility of some of the country's financial institutions; the under-funding or maladministration of the country's industrial (and, to some degree, military) pension system; unsafe working conditions in many enterprises, especially coal mines; and restrictions on the free practice of religion, outside of government-authorized churches.

China's vulnerability to problems like these is increased by the rigidities of its political system. Although there has been some political reform – primarily in the direction of a freer society, a more capable bureaucracy, greater rule by law, and greater attention to public opinion – the responsive mechanisms of the political system remain underdeveloped, particularly at higher levels. There remain significant restrictions on the press, on the

communication of dissent through the Internet, on the creation of non-governmental organizations, on the use of elections to select officials – in other words, significant limits on pluralism and democratic processes more generally.

These rigidities mean that the Chinese political system lacks what is called "procedural legitimacy" (legitimacy that comes from responsive and accountable political institutions), and is excessively dependent on "performance" legitimacy (the ability to satisfy the material expectations of the Chinese people and their demand to enhance their country's international standing). It also means that the system is more susceptible to shock and thus to a political crisis.

This combination of social grievance and political rigidity has already produced political unrest, with some 74,000 protests occurring in 2004. So far, the problems have been localized – they have mainly focused on local issues, have been directed at local governments, and have been dealt with by local leaders (albeit under guidance from higher levels).

However, there is a real danger that these problems, and the unrest they cause, will break out of these local frames and take on a more national character. This could occur under any of the following circumstances:

- A problem emerges that transcends local and regional boundaries. The benzene spill in Jilin province is one recent example, since it ultimately affected not just Jilin but also Heilongjiang and Russia. Similarly, a pandemic (SARS, AIDS, avian flu) would immediately become a national problem, as would a significant economic problem such as recession or inflation.

- A problem occurs that, although possibly not severe in itself, reveals the culpability of higher-level government officials. (Examples might include serious cases of high-level corruption, especially those that had economic or societal consequences, such as a bank failure, the bankruptcy of a major state-owned company, or the collapse of a major physical structure, such as a dam or a building).

- A nationwide opposition movement begins to develop, either at the grass roots level or among intellectuals or other elites, which portrays what had previously been regarded as an unconnected set of local problems as part of a broader pattern for which the national government bears responsibility.

- The national leadership begins to divide over how to cope with these problems, or how to handle the protests that they have produced.

These developments could trigger, either immediately or gradually, a national political crisis, in which dissatisfaction and dissent begins to overwhelm the ability of existing political mechanisms to cope. The severity of that crisis can in turn be measured along several dimensions: how large any protest movement becomes, how long the crisis lasts, and whether it involves violence and loss of life. The consequences of the crisis, specifically the changes that would be brought as a result are the following:

- A **policy crisis** is one in which there is significant policy change. In fact, one could argue that China is already experiencing a quiet policy crisis, given the extent to which the priorities advocated by Hu Jintao and Wen Jiabao and contained in the new five-year plan represent a major change of direction from the policies of the Jiang Zemin administration. Some of the changes may be seen as progressive (greater emphasis on social security, education and public health, environmental protection, and the like), while others can be regarded as regressive (tighter controls over the internet, the press, and non-governmental organizations).

- A **leadership crisis** is one in which political tensions are sufficiently great to force changes in leadership, particularly changes that occur "out-of-cycle" or through abnormal mechanisms. Again, the beginnings of a mild variant of this phenomenon can be seen, in that local leaders (including provincial level officials) are being dismissed (or asked to "resign") as part of the Party's response to serious local problems. Examples include the resignation of the head of the State Environmental Protection Agency after the benzene spill in Northeast China, and the dismissal and prosecution of provincial and municipal officials on corruption charges. So far, few of these leadership changes have occurred at the national level, but the possibility cannot be ruled out in the foreseeable future. Leadership crises can subsequently produce an unresolved struggle for power, which can produce further instability at both the elite and the grassroots levels.

- An **institutional crisis** is one in which problems become so severe as to force changes in the political structure. The outcome of such a crisis can be either progressive or regressive in nature. In China's case, for example, it is possible that future Chinese leaders might decide to increase the level of political pluralism, or even to increase the extent of grass-roots democracy, in an attempt to restore their legitimacy. (This would then fall into the category of "succeeding beyond expectations," rather than "faltering.") But other outcomes would be far less positive. It is possible that there could be greater military involvement in elite politics, if the civilian leadership comes to rely heavily on the military to ensure domestic order. (The military would probably rule through the Party, as was the case during the Jaruzelski period in Poland and during China's own Cultural Revolution, rather than overthrowing the Party through an overt military coup and ruling in its own name.) Or there could simply be a sustained and institutionalized tightening of controls over Chinese society. The chances of such a crisis are presently lower than the prospects for a leadership crisis, but they are not insignificant.

- A **systemic crisis** would involve a significant reduction in the coherence of the nation-state. This could entail political decay, in which the coherence of political institutions is significantly weakened, making it more difficult to address various social and economic problems, up to the point that China becomes a "failed state." It could involve a sustained insurgency, either urban or rural or both, aimed at overthrowing the existing political institutions and replacing them with new leaders and new organizational forms. Or it could involve secessionist movements – in China's case presumably ethnic in nature – which seek to separate from the larger political entity and create an independent

nation-state. At this point, the probabilities of a systemic crisis are relatively low, given the resources still available to the central Chinese government.

The impact of these crises on the international community depends both on their severity and the direction of any subsequent structural change in policies or structures. Crises that yield "progressive" outcomes – policies that promote human welfare and environmental protection, institutional changes in the direction of greater pluralism and democratization – would be generally welcomed by the international community. Crises that lead to repression and the tightening of political controls would cause significant tensions in Beijing's relations with some other countries, particularly democracies such as the United States, Europe, and possibly Japan, and might even lead them to impose sanctions against China. Crises that generated secessionist movements might attract international support, although the level of that support would depend in part on the inflexibility of the Chinese government and the willingness of the secessionist movements to refrain from terrorist tactics. Crises that produced political decay and internal violence would produce significant humanitarian problems, some of which could cross international borders, and would interrupt international economic flows.

Conclusion

In short, China is more vulnerable at present to some kinds of crisis than to others. Of greatest concern are humanitarian crises produced by environmental degradation or communicable disease. International crises are unlikely in the immediate future, unless Beijing feels provoked by others. Economic problems can probably be managed short of hyperinflation or depression, unless the shock to the Chinese economy is unusually great. In the political realm, the likelihood of a policy crisis or a leadership crisis is greater than that of an institutional crisis or a systemic crisis. In each case, the likelihood and severity of a shock, or a trigger event, is as important as the gravity of the underlying problems and vulnerabilities.

The consequences of these crises for the international community obviously depend in part on their severity, but even more importantly on the existence of mechanisms that carry the consequences of crisis beyond China's borders. A financial crisis in China might not have a broad impact on the international economy, given the controls on capital flows across China's borders. In contrast, international trade flows could not be protected from a significant recession in China. A natural disaster, a minor environmental incident, or a localized outbreak of communicable disease would have relatively few international consequences, but an epidemic of a communicable disease or a significant environmental catastrophe could have regional or global implications. A political crisis in and of itself might not have international implications, unless it produced such problems as illegal migration across China's borders, or unless it produced such high levels of political and social instability as to have economic consequences.

The possibility that a political crisis could have economic consequences leads to a consideration of the connections among these four kinds of crisis. Although those four

have been discussed separately so far, they could interact in mutually exacerbating ways. To cite only a few of the possible combinations:

- A humanitarian crisis could trigger an economic crisis if it caused a reduction or suspension of economic activity.

- A severe economic or humanitarian crisis could trigger a political crisis if the Chinese government were perceived as responsible for causing the crisis or incompetent in managing its consequences.

- A political crisis could trigger an international crisis if it led the Chinese government to launch a "distractive war" or led other countries to impose sanctions against China.

- A political crisis could produce a humanitarian crisis, or an economic crisis or both, if it caused widespread political instability and decay.

- An international crisis might trigger an economic crisis if it generated economic sanctions against China.

In other words, there is the danger of a cascading effect. The more serious one form of crisis, the more likely it is to serve as a trigger for other kinds of crisis, and the more the crises are interconnected, the more likely they are to have international consequences.

Finally, a few words about longer-term trends. The analytical model used in this paper implies that the likelihood of crisis over time depends on whether problems can be resolved, whether adaptive mechanisms can be improved, and whether triggers or shocks can be avoided. Since triggers are often random events, which can neither be prevented nor even predicted, the focus should be on reducing vulnerability by resolving underlying problems or enhancing a society's capability to adjust.

Much depends, therefore, on the policies now being adopted by the new Hu-Wen leadership in China. The good news is that they are addressing a number of economic and social issues that are presently generating political grievances, and that they are trying to reassure their neighbors about China's economic and strategic intentions. The bad news is that they appear to believe that they can improve their government's ability to respond to crisis without increasing the level of pluralism and transparency. In effect, they are trying to smooth out the road ahead, without improving the efficiency of their shock absorbers.