# Report of the China Task Force

## Executive Summary

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Report issued 26 May 2006

Prepared for Japan External Trade Organization (JETRO)

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Introduction

We need to be prepared for difficulties and risks. Some of these may be predictable, but others may not.

– Wen Jiabao, March 14, 2006

People around the world are concerned with the risks associated with developments in China. This reflects both the importance of China – its size, strategic location, and geopolitical ambitions – and the uncertainties surrounding its future. As the quotation from Chinese Premier Wen Jiabao above indicates, many Chinese share those apprehensions.

The uncertainties about China fall into two broad categories. In their most extreme form, these are the risks that would stem from China’s failure and those that would arise from China’s success. Despite impressive economic successes over the last 25 years, China could still encounter severe internal problems. These include environmental and public health crises, either a gradual or a sharp downturn in its economy, political instability, and repression of dissent. These domestic problems could have significant implications for the rest of the international community. Environmental and public health problems could spill over Chinese borders. A downturn in the economy would hurt the economic prospects of those that export to China and those who have invested in it. Serious political instability would disrupt the supply chains of firms operating in China, and could make Beijing far more apprehensive of the intentions of other powers. Repression of dissent would reintroduce the human rights issue into China’s relations with a number of major powers.

But risks could emerge from success as well as failure. A rapidly growing Chinese economy will draw more energy and natural resources from the rest of the world, placing upward pressure on commodity prices. A more efficient Chinese economy will put strong competitive pressures on business around the world. A more democratic China could become a more nationalistic China, more insistent on asserting its national interests, and less willing to compromise on international issues. And a more powerful China will change the international balance of power, either giving Beijing greater weight in international affairs, or possibly causing the creation of a countervailing alignment against it.

This report offers an assessment of the risks associated with likely developments in China over the next ten years (from 2006 though 2016). It is concerned with both the risks that China will face as it grapples with the dilemmas and contradictions of rapid change, and the risks that China’s evolution will pose to the rest of the international community, particularly Japan and the US. Although the report focuses primarily on the risks to national societies (China, Japan, the US, etc.), it also identifies some of the risks faced by multinational corporations and by international regimes and institutions.

The report is the product of a task force supported by Eurasia Group, the Japan External Trade Organization (JETRO), the Japan Economic Foundation, and PricewaterhouseCoopers (PwC). The task force was led by a core group, which included five China specialists at Eurasia Group (Harry Harding, Jason Kindopp, Sijin Cheng, Erik Tollefson, and Peijean Wu), three leading outside specialists (Pieter Bottelier of Johns Hopkins University, Kenneth DeWoskin of PwC and the University of Michigan, and Akio Takahara of Tokyo
University), and representatives from JETRO and the Ministry of Economy, Trade, and Industry (METI). Lisa Weiss of Eurasia Group provided administrative support.

The task force convened a series of six, day-long workshops, each dealing with a particular aspect of risk in China: demographic and environmental risks, risks associated with energy and resource utilization, economic risks, business and commercial risks, social and political risks, and international risks. For each workshop, the task force commissioned a series of papers from outside scholars that reviewed the most important trends and the most important risks with regard to the subject in question. Another set of analysts provided oral commentary on the papers, and then wrote a short paper on what they regarded as the most important conclusions to emerge from the workshop that they attended.

Building on these papers and commentaries, and on the intensive discussions that took place during the day-long workshops, the task force then drafted its report. It began by charting the major trends that will characterize China over the next ten years. It then identified the major risks, both for China and the international community, that may flow from those trends. Next, it attempted to assess the relative severity of the risks – their probability and their likely impact on China and the rest of the world – not only as individual developments, but also as risks that might interact with one another.

Finally, the task force identified the most important recommendations that flow from the analysis. Some of these are directed at the Chinese government, while others are aimed at foreign governments and international organizations, and at the international business community. The full report also contains four comprehensive scenarios – ranging from fairly optimistic to quite pessimistic – that illustrate the range of possible long-term futures that China may face.

Despite its length, the report makes no claim to be completely comprehensive. Many of the risks the task force has identified subsume other, more specific issues. For example, the report does not attempt to catalogue all the specific international problems that could produce bilateral tensions or provoke an international crisis. Nor does it provide a separate analysis of all the conceivable environmental risks or natural disasters that China could face over the next ten years. Instead, the report provides a broad analysis of China’s future, attempting to identify the general categories of risk rather than to analyze any of them in exhaustive detail. Moreover, given the fact that Eurasia Group specializes in assessing political risk, the focus of the report is on identifying and forecasting political trends and risks, rather than on economic forecasting.

**Charting the trends**

The task force identified 22 key environmental, demographic, economic, commercial, social, political, and international trends that will shape China’s future over the next ten years. These are summarized on the following pages. Underlying these specific trends are several broader propositions about China’s trajectory, past and future.
## The Key Trends

<table>
<thead>
<tr>
<th>Trend</th>
<th>Description</th>
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<tbody>
<tr>
<td><strong>Increasing pollution</strong></td>
<td>China suffers from an increasingly polluted environment, in terms of air, water, and soil.</td>
</tr>
<tr>
<td><strong>Worsening shortages of water and arable land</strong></td>
<td>China is facing increasingly severe shortages of potable water and a shrinking supply of arable land.</td>
</tr>
<tr>
<td><strong>Looming demographic challenges</strong></td>
<td>Given its one-child policy and declining mortality rates, China will soon experience the effects of dramatic aging of its population. Already, because its birth control policies have produced an abnormal male-to-female ratio and a large number of only children.</td>
</tr>
<tr>
<td><strong>Mounting public health problems</strong></td>
<td>China is experiencing several public health challenges, in terms of both the spread of communicable diseases and the decay of its public health system, particularly in rural areas.</td>
</tr>
<tr>
<td><strong>Imbalanced growth</strong></td>
<td>China is achieving high rates of economic growth, but with significant macroeconomic imbalances, most notably high savings, high investment, low consumption, and high reliance on exports.</td>
</tr>
<tr>
<td><strong>Incomplete transition</strong></td>
<td>China’s transition from plan to market is still incomplete, with government intervention in strategic sectors of the economy, state control over the value of China’s currency and the prices of certain commodities, and a bias against allocating capital to private enterprises.</td>
</tr>
<tr>
<td><strong>Increasing use of energy and raw materials</strong></td>
<td>As a result of rapid industrialization and urbanization, China is consuming increasing amounts of energy and raw materials, and is using them inefficiently.</td>
</tr>
<tr>
<td><strong>Stronger financial system</strong></td>
<td>China’s financial system is healthier than in the past, but with continued misallocation of bank lending and with poorly institutionalized capital markets.</td>
</tr>
<tr>
<td><strong>Increasing fiscal resources</strong></td>
<td>The government’s fiscal resources have increased, but are poorly allocated among different levels of government. Local governments face numerous unfunded mandates.</td>
</tr>
</tbody>
</table>
## THE KEY TRENDS (cont’d)

<table>
<thead>
<tr>
<th>Description</th>
<th>Details</th>
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<tbody>
<tr>
<td>Growing urbanization and inequality</td>
<td>China is experiencing increasing urbanization, first along the coast, and now in the interior. This process is producing upward social mobility and increased prosperity for many, but is also generating growing interregional and interpersonal inequality.</td>
</tr>
<tr>
<td>Increasing interdependence and vulnerability</td>
<td>China has become increasingly interdependent with the outside world. This access to export markets, foreign capital, and advanced technology has brought many benefits, but has also made China vulnerable to global economic trends.</td>
</tr>
<tr>
<td>Growing economic nationalism</td>
<td>China has adopted what some describe as a “mercantilist” foreign economic policy, aimed at promoting “national champions,” acquiring foreign assets, limiting foreign investments in critical sectors, building reserves of physical commodities and foreign exchange, and reducing dependence on imports of foreign technology.</td>
</tr>
<tr>
<td>Greater “rule of law”</td>
<td>China’s legislative, judicial, and regulatory mechanisms are increasingly transparent, but both the rule of law and the enforcement of property rights are still inadequate.</td>
</tr>
<tr>
<td>Impending labor shortages</td>
<td>Despite a large and growing labor force, China is already experiencing shortages in some areas that are driving up labor costs. Over time, the number of new entrants into its labor force will stabilize and then actually decline.</td>
</tr>
<tr>
<td>More effective bureaucracy</td>
<td>China’s bureaucratic system has become more technocratic than ever before, but it suffers from imperfect mechanisms of intra-bureaucratic coordination and from high levels of corruption.</td>
</tr>
<tr>
<td>More regularized political process</td>
<td>China’s political process, including its succession arrangements, is now more regularized, but is still incompletely institutionalized.</td>
</tr>
</tbody>
</table>
As the Chinese state has relaxed its control over society, and as China has become more integrated with the rest of the world, Chinese citizens have access to more channels of interpersonal and mass communication. The state struggles to restrict the content of those communications flows, particularly on sensitive political issues, but cannot block them altogether.

Various socio-economic problems are producing increasing tensions between state and society, but the state lacks adequate mechanisms with which to hear and respond to popular grievances.

There has been a clearer separation of civilian and military institutions, and greater civilian control over the military, but the Peoples Liberation Army (PLA) still enjoys a privileged position within the Chinese party-state.

China has improved its bilateral relations with most other countries, and has largely completed its integration into international regimes and institutions.

China's influence in international affairs is growing, as a result of the growth of its economy and its foreign economic relations, the modernization of its armed forces, and its more active diplomacy.

Although Beijing has stated that its economic and military development will be peaceful, growing popular nationalism is raising concerns about the long-term orientation of Chinese foreign policy.

Despite its growing international integration, China is still experiencing tensions with a number of other nations, particularly Japan and the US, over concrete international issues and the definition of international norms.
First, China’s structural transformation since 1978 – what Chinese leaders have described as a process of “reform and opening” – has achieved impressive results. China has achieved and maintained high rates of economic growth. As a result, millions have been lifted out of poverty, and millions of surplus rural workers have found jobs in urban areas. Hundreds of millions of urban Chinese have entered a new middle class. State control over society has been significantly relaxed, with individual citizens enjoying far more social and economic freedom than at any time since 1949. The political system is far more institutionalized than ever before.

China has also been successfully integrated into the international economy. China has become a major trading nation, first as a successful exporter of manufactured goods and an importer of technology, and more recently as an importer of energy and raw materials as well. It has also become extensively engaged in foreign direct investment, first as a recipient of incoming investment, and now as an exporter of capital as part of a policy of “going global.” China is becoming more integrated with the international financial community, with foreign institutional investors gradually being permitted to invest in Chinese equity markets, and domestic institutional investors allowed to invest Chinese capital abroad.

However, in several important respects these transitions remain incomplete. China retains several features of its previous political and economic systems: a preference for state control over key aspects of the economy, even though much of the economy has been marketized; a preference for state-owned (or at least state-controlled) industry, despite the fact that much of the economy has been privatized; a reluctance to accept genuine political pluralism, let alone democracy, even though state control over society has been relaxed; and a mercantilist approach to foreign economic relations, despite China’s extensive integration into the global economy.

Moreover, China’s development has thus far been highly imbalanced. Until recently, Chinese leaders have focused rather single-mindedly on economic growth. This is understandable, given Beijing’s desire to find jobs for a growing labor force and for the large numbers of surplus agricultural and industrial laborers. But the preoccupation with growth has come at a cost. Inadequate attention has been paid to the problems of environmental degradation and shortages of water and arable land. The economic transformation has produced growing social and economic inequality, such that China has evolved from one of the most egalitarian societies in the world to one of the most unequal. China’s economic growth has been extensive rather than intensive, depending more on increasing the volume of inputs (such as capital, raw materials and labor) rather than using those inputs more efficiently. And growth has depended overwhelmingly on investment and exports rather than on domestic consumption. The sustainability of this pattern of growth is open to considerable doubt.

Looking ahead, several key problems, already evident, are likely to become even more severe over time. Environmental issues, including pollution and shortages of potable water, are likely to intensify over the next decade. The main features of China’s demographic transition – the decline in the number of new entrants into China’s labor force and the increasing proportion of elderly in the population – will begin to become apparent around ten years from now. This demographic change is likely to produce long-term economic and social problems, including the eventual reduction in the size of China’s total labor force, and difficulties providing adequate social security and medical care for China’s aging population, particularly in rural areas.

Finally, China’s rapid economic growth, its integration into the global economy, and the modernization of China’s armed forces, are all increasing Beijing’s international presence. China’s high degree of economic interdependence and its integration into international regimes and institutions mitigate the impact of these developments to some degree. Beijing has sought to improve its relations with most other countries, as part
of its strategy of maximizing access to capital, markets, technology and resources abroad. And China insists that its rise will continue to be peaceful.

But the emergence of a great power is always difficult, particularly one of China’s size and strategic location. And China has unresolved territorial claims with some of its neighbors, has different views of history than Japan, prefers different international norms and institutions than the US, and is likely to experience an expansion of its interests as its national power and international engagements expand. As a result, there are already significant tensions between China and several other major powers, including both Japan and the US. Moreover, much of the Chinese public still sees their country as a victim of past international developments, rather than as a successful beneficiary of more recent trends. Popular nationalism in China therefore has taken an aggrieved tone that may complicate the management of international disputes in which Beijing becomes involved.

Identifying the risks

After charting the key trends that will shape China over the next ten years, the task force identified what it regarded as the 21 most important risks that would follow from those trends. The task force considered both the risks that might emerge inside China, and the risks that China might pose for its neighbors and the rest of the world.

The risks are grouped into five clusters:

- **Humanitarian risks**: Environmental and health problems that would threaten the physical well-being of individuals inside and outside China.
- **Economic risks**: Developments that would threaten the prosperity of the Chinese economy and the world economy.
- **Commercial risks**: Developments that would threaten the profitability of foreign firms, whether operating in China or not.
- **Political risks**: Developments that would threaten the viability and stability of the Chinese political system.
- **International risks**: Developments that would threaten the balance of power or the stability of the international order.

In assessing the relative severity of these 21 risks, two separate dimensions were examined. First, the probability that the risk will materialize is estimated. It is difficult to calculate the probabilities of these risks with great precision, especially over the ten-year time frame of this report. Instead, risks were assigned to three general levels of probability: high probability (between 70% and 100%), moderate probability (between 30% and 70%), and low probability (less than 30%).

Second, the task force assessed the likely impact of each risk on those affected inside and outside China. “Higher impact” risks carry the potential for significant loss of life, major economic loss, or threats to the survival of governments and other institutions that are either impossible to avoid or that would require extensive time, effort and resources to mitigate or overcome. “Lower impact” risks, in contrast, have a more...
modest impact on the vital interests of affected parties, but would still have more significant impact on other interests, requiring considerable time and effort to reduce or overcome.

In many cases, however, the impact of a risk, if it materializes, will vary according to the circumstances. For example, the severity of an earthquake in any specific location will range from high to low, depending on the temblor’s intensity, the distance from the epicenter and the geology of the area. Inflation can take the form of modest price increases (low single-digit inflation), higher but still tolerable price increases (higher single-digit or double-digit inflation), or hyperinflation (in which price increases are so great that the viability of both the economy and the political system are called into question). These kinds of risks have “variable impact,” depending on the severity of the specific event, or shock, that triggered them, and on the ability of governments and other actors to mitigate their consequences. (For a summary of the key events that might trigger some of these risks, see the box below.)
On the basis of our assessment of their relative probability and impact, the task force divided the risks into nine categories:

<table>
<thead>
<tr>
<th>High probability, severe impact</th>
<th>Moderate probability, severe impact</th>
<th>Low probability, severe impact</th>
</tr>
</thead>
<tbody>
<tr>
<td>High probability, variable impact</td>
<td>Moderate probability, variable impact</td>
<td>Low probability, variable impact</td>
</tr>
<tr>
<td>High probability, mild impact</td>
<td>Moderate probability, mild impact</td>
<td>Low probability, mild impact</td>
</tr>
</tbody>
</table>

It is important to emphasize that these two dimensions of risk – probability and impact – are not highly correlated. Risk analysis often focuses exclusively on probability, paying most attention to developments that are most likely to occur. And yet, our assessment of risk suggests that not all risks that are highly probable will have the most severe impact. Conversely, some risks that are relatively unlikely could have very serious consequences if they should occur. Attention should be paid to risks that have either higher probability or higher impact, with particular concern devoted to risks that are ranked high on both dimensions.

Humanitarian risks

Environmental crisis
China faces extremely serious environmental issues, including both a shortage of water and pollution of air, water, and soil. Environmental crises are highly probable, and the most severe of them could have a significant impact on the economy and public health. These could include toxic spills from factories, possibly affecting millions of people; chronic air pollution alerts in major cities; and acute shortages of water in either rural or urban areas. In addition, much of China lies in earthquake zones. Although most earthquakes will be of relatively low intensity and do relatively little damage, a high magnitude earthquake could have catastrophic consequences, particularly if it occurred in an urban area or affected a major dam or a nuclear power plant. Floods along rivers and typhoons along the coast pose similar problems, with severe impact if they destroy critical infrastructure or if they do significant damage to major cities. (High probability, potentially severe impact)

Epidemic
Given the close proximity between humans and animals in much of the country, there is a high probability that viruses previously specific to animals could make the jump to humans. Depending on the contagiousness and virulence of any given disease, and depending on the government’s ability to contain it or cure it, outbreaks of acute disease (such as SARS and avian flu) could have catastrophic consequences, not only for China but for neighboring countries and possibly for the world. Further spread of existing chronic diseases (such as HIV/AIDS) would have less immediate consequences, but over the longer term they could seriously strain China’s public health systems and ultimately the entire economy. (High probability, potentially severe impact)
Economic risks

Financial crisis
The probability of the failure of a major financial institution is low, because of the recapitalization of China's major state-owned banks, the gradual introduction of foreign equity and the adoption of foreign management practices by those banks, and the Chinese government's ability to bail them out should they become insolvent. Although other financial institutions (smaller banks and brokerages) are on less sound footing, the government should have the ability either to prevent their failure or to manage the crisis. If a crisis should occur, its impact will depend on the ability of the Chinese government to use effective policy tools to mitigate the consequences. (Low probability, variable impact)

Domestic inflation
China will never be immune from the business cycle and, like all economies, remains vulnerable to both inflation and recession. Inflation could result from either internal or external sources. Likely causes include an increase in wages resulting from shortages of skilled labor and managerial talent; a surge in domestic investment, given the weaknesses in the banking system; an increase in commodity prices, particularly of imported energy resources; and an increase in government spending, to deal with various social and economic problems. The severity of the risk would depend on the Chinese government's ability to use fiscal, monetary and administrative tools to reduce inflationary pressures by slowing demand. (High probability, variable impact)

Domestic recession
China could experience a sharp domestic recession – defined as a slowdown in economic growth, a decline in prices, or both – again as a result of domestic or international factors. The overcapacity of Chinese industry is one source of deflationary pressures, as is excessive urban construction in some cities. Developments that reduced foreign demand for Chinese exports, such as a terrorist attack that disrupted world trade, a sharp downturn in one or more of China's trade partners, a sudden revaluation of the Chinese currency relative to key currencies, or protectionist measures directed against China, could all cause a recession. The level of risk depends on the severity of the triggering event, and on the ability of the Chinese government to adopt effective stimulatory policies to overcome it. Over the longer term, overall levels of economic growth in China are almost certain to decline, as China's economy matures and as the size of its labor force eventually peaks and declines. (High probability, variable impact)

Commercial risks

Deterioration of business climate
Foreign firms operating in China may be the victims of growing economic nationalism and protectionism, from both the Chinese government and Chinese society. Foreign firms may discover that the previous privileges they received while investing and operating in China are gradually removed in the name of creating a more “level playing field.” They may also find that the regulations governing their operations are enforced more stringently, and that in the future their Chinese competitors receive advantages through various forms of government regulation and through preferential access to capital. Moreover, if there are tensions in the relations between China and their home governments, this may be reflected in protests or consumer boycotts. Such protests have thus far been relatively short lived, but given rising Chinese nationalism these risks may increase over time. (Moderate probability, variable impact)
Disruption of supply chains
Foreign firms face the risk of various threats that could disrupt their supply chains in China. These would include natural disasters that destroyed critical infrastructure, environmental or health crises that prevented employees from coming to work, or serious political instability that interfered with the smooth functioning of the economy. Protectionist measures directed by foreign governments against Chinese exports would put manufactured goods considered to be of Chinese origin at a disadvantage, as would a significant revaluation of the yuan. The severity of the risk depends on the severity of the trigger event, on the speed with which any disruption can be overcome, and the availability of alternative supply chains. (Moderate probability, variable impact)

Value destruction
As dynamic Chinese firms move up the value chain, acquiring greater ability to design, produce, brand, and distribute goods and services on their own, foreign firms will face greater competition in China, their home markets and third country markets. In addition, they will find that Chinese firms will attempt to capture more of the value chain in each sector in which they operate, particularly with regard to intellectual property. Intellectual property risks include not only the possibility that brands, patents, and trademarks will be pirated, but also that the Chinese government will require the transfer of advanced technology by foreign investors and will try to reduce the amount of royalties paid to foreign patent holders. In sum, not only will Chinese firms set a low “China price” for many tradable commodities, but they will also seek to capture more of that price for themselves. (High probability, potentially severe impact)

Commodity inflation
Whether they operate in China or not, foreign firms may see the impact of China on the prices of various natural resources, including energy and minerals. Although resource use is closely related to a country’s stage of development – with cement and iron, for example, used at earlier stages than aluminum or platinum – China’s size and complexity mean that different parts of the country will pass through these stages at different times, contributing to upward pressure on international prices for a protracted period. At the same time, the uncertainties surrounding levels of Chinese investment, Chinese policies to build reserves of key commodities, and the Chinese tendency to trade actively in futures markets will increase the volatility of commodity prices. (High probability, variable impact)

Reputational risk
Foreign firms run a reputational risk in their home markets because of their decision to operate in China. These risks involve the perception, on the part of customers, stockholders and the home government, that they are engaged in dangerous or improper practices. They may be accused of “exporting” local jobs to China, so as to benefit from the lower labor costs. They may also be charged with taking advantage of the absence of effective Chinese trade unions to pay their Chinese employees substandard wages or to require them to work in unsafe conditions. They may additionally face criticism that, because of inadequate Chinese environmental standards, their production facilities are causing some form of environmental damage. They may also be subject to accusations that they are selling or transferring advanced technology to China that could strengthen its military strength. (Moderate probability, variable impact)

Political risks

Bureaucratic immobility
As the Chinese government becomes more institutionalized, and as political interests become more complex, there is a high probability that it will become increasingly difficult for the central government to arrive at well-
coordinated policies or to implement them in a timely manner. Economic reforms have proceeded to the point that an immobilized government would still allow much room for domestic and foreign commercial activity, but such a situation would also increase the risk that China would be unable to deal effectively with long-term problems such as aging, disease, corruption, inequality and environmental degradation. (High probability, variable impact)

**Leadership crisis**

The relative institutionalization of the Chinese political system has reduced the possibility of a severe leadership crisis, defined as struggle for power outside of regular mechanisms and outside of normal timetables. China will continue to see competition for power at both national and local levels, as in any political system, but the mechanisms for selecting leaders are likely to work reasonably well, and the large number of Party and government positions that are available at each level reduces the zero-sum character of the competition. However, if the competition for power cannot be resolved, the prospects for a wider destabilization of Chinese politics would increase significantly. (Moderate probability, potentially severe impact)

**Popular unrest**

Political unrest is increasingly likely to be a feature of the Chinese political scene as the complexity of Chinese society increases. In the near term, protests are likely to remain largely localized, or else to involve episodic unrest in major cities or a low level of national political opposition, rather than reach the level of dissent that could threaten the overall stability of the regime. However, if the government is unable effectively to address the problems that have given rise to protest, or if a significant humanitarian, economic, or international crisis occurs, the level of unrest could rise to more serious levels. (High probability, variable impact)

**Military intervention in politics**

Because of the level of political institutionalization, military intervention in politics – whether through a coup, at the behest of civilian leaders, or as part of a bargain to secure military support for a weak civilian leadership – is also regarded as relatively unlikely. Even if there were such military intervention, the impact on policy is likely to be moderate, given the military’s interest in maintaining high levels of political stability and economic growth (Low probability, mild impact)

**International risks**

**Transnational crime**

Transnational criminal activity – smuggling of goods, trafficking in people, or organized crime based in China – is likely to remain mild in severity, although high in probability. The exception to this generalization would be a terrorist attack designed to kill large numbers of people or to destroy critical infrastructure in China. (High probability, generally mild impact)

**Nationalism**

The rise of popular nationalism is also a high probability risk. The authoritarian nature of Chinese politics will limit the impact of nationalism on government policy making. However, nationalistic sentiment may still reduce the government’s ability to respond flexibly and responsibly to international crises, particularly in times of political instability or leadership disunity (High probability, variable impact)

**Bilateral tensions**

Tensions in China’s relationships with other nations are a virtual certainty. Disagreements are likely across a wide range of issues, including human rights, trade and investment patterns, territorial disputes, competition...
for resources, and relative influence. However, China’s high degree of interdependence with the rest of the world, and its desire to maintain a peaceful international environment, should help keep these disputes manageable. The greater risk is the cumulation of disputes, particularly with nations whose relationships with China are characterized by a lack of mutual trust. (High probability, generally mild impact)

**Crisis triggered by others**
A major international crisis, caused by a challenge to Chinese interests that Beijing regarded as intolerable, would have extremely significant consequences for the international system. The most worrying possibility would be a decision by Taiwan to move toward declaring its legal independence – an event that could produce a crisis, or even military confrontation, between China and the US. However, China could also face other challenges to its interests around its periphery (particularly in Korea, Central Asia, and in disputed areas at sea) and increasingly farther away from its borders (especially in Africa and the Middle East) as its foreign economic activities expand. Although the impact of such an international crisis would be severe, its probability is relatively low, since other powers will increasingly seek to avoid provoking a crisis with China. (Low probability, potentially severe impact)

**Crisis triggered by China**
An international crisis could also be triggered by a Chinese attempt to advance its national objectives in ways that other nations found unacceptable. The most likely scenarios in this regard would be a Chinese attempt to pursue its territorial claims with regard to Taiwan, the South China Sea, or the East China Sea. However, for the next ten years China will seek to avoid crisis because of its preoccupation with internal development and stability. Thus, although the impact of this risk would be high, its probability is low. (Low probability, potentially severe impact)

**Polarization**
Either a specific international crisis, or a gradual escalation of tensions over broader economic and security issues, could produce an enduring international alignment against China – what some describe as a “new cold war” in Asia. There is also the possibility that China might, in turn, align with Russia and other countries against the US and Japan. The consequences of such a confrontation, were it to occur, would be significant in terms of both the actual costs (military preparations) and the opportunity costs (foregone economic opportunities and a reduced ability to solve common international problems). However, the level of international interdependence – far greater than between the Soviet Union and the West at the beginning of the first Cold War – significantly reduces the probability of this occurring. (Low probability, severe impact)

**Shift in the balance of power**
If China continues to grow, even at less than its recent rates, and if its military power and diplomatic activity continues to increase, its power in the international system will also grow. Other things being equal, this will lead to a shift in the overall balance of power, both regional and global, in China’s favor. Other powers – including Japan and the US – will have to more fully consider China’s interests in shaping their foreign policies, and will have to devote more attention and resources to competing with China for influence in other countries. However, unless other powers fail to compete effectively, or unless they allow their own economies and military forces to fall behind, the balance of power will remain sufficiently robust to prevent China from achieving hegemony, either regionally or globally. (High probability, variable impact)
Assessing the risks

Comparative severity

As already noted, the task force has assigned estimates of probability and impact to each of the 21 risks that it identified. These estimates are summarized in the chart below.
As the chart on the previous page shows, the most worrying risks are those that combine high probability and severe impact. The task force has concluded that three risks fall into this category: the risk of an environmental crisis, the possibility of a major epidemic, and competitive pressures from Chinese firms on the rest of the economy.

There are many other risks that are highly likely, or even virtually certain, to occur, but their impact may be somewhat less. These include most of the domestic economic and political risks to China, as well as a shift in the international balance of power in China’s favor. Here, the challenge will be to identify and implement strategies for managing or reducing the impact of the risk.

Other risks are less likely to occur, but the consequences could be highly significant if they do. The most important of these are the risks of an international crisis, whether triggered by China or triggered by some other power, and the possibility that this could spill over into a more enduring polarization of the international system. Similarly, a leadership crisis, if it occurred, could lead to a polarization of the Chinese political system, with significant consequences for China’s internal stability. Given the severe impact of such risks, the challenge is to prevent them from materializing in the first place.

Most of the risks to foreign businesses operating in China – except for “value destruction” and commodity inflation – are of a lower probability. “Lower,” however, is a relative term. The probability is still significant (30-70%), and the impact could conceivably be severe. Foreign firms need to be aware of these risks, and take appropriate strategies to reduce their probability or mitigate their consequences. The section on recommendations, below, offers some suggestions as to how this might be done.

Temporal trends

These assessments of the relative severity of the risks related to current developments in China represent snapshots of their probability and impact today. But some changes in those risk assessments could occur over the ten-year time frame covered by this report.

Over the last several years, the Chinese government has been attempting to mitigate several of the most important risks. It has tried to reduce the risk of a banking crisis through the recapitalization of the banks and the introduction of foreign ownership and management to change the lending culture. It has attempted to reduce the severity of potential environmental and public health crises by requiring more rapid and honest reporting of such environmental incidents and outbreaks of infectious diseases when they occur. It has developed a number of policy instruments – fiscal, monetary, and administrative – to deal with both inflationary and recessionary pressures, and has shown its ability to use them reasonably effectively over the last decade. And it has tried to reduce the chances of international crisis and of an international alignment against Beijing by assuring other nations of its intention to develop peacefully.

More recently, China’s top political leadership has announced several additional policies intended to further mitigate some of these same risks and to reduce the probability or impact of others. These include more stringent environmental regulations, attempts to increase efficiency of energy use, policies to improve access to health care, programs to provide pension support to China’s elderly, policies to rectify China’s economic imbalances, attempts (short of democratic elections and organized political pluralism) to gauge public opinion and preempt protests, measures to promote poverty alleviation, and policies to redress other public grievances.
But despite these remedial measures, the probabilities of most of the risks identified in the report are likely to increase with the passage of time. This is so for several reasons.

First, some of the risks are the result of demographic trends that are now inescapable. China is an aging society; the size of its labor force will soon peak and begin to shrink; it is suffering from a surplus of men over women; many of its young people are only children. The aging of the population will strain China’s pension and public health systems. The decline in the size of the labor force will exert upward pressure on wages, and may make it impossible for China to continue a labor-intensive strategy of economic development. The surplus of young men may produce an increase in crime and social unrest. However one assesses the risks associated with these trends, the trends themselves cannot be reversed during the time period of this study. Indeed, they can only become more pronounced. But the full impact of some of these risks – especially those associated with the aging of the Chinese population – will not become apparent until the years after 2016, beyond the time frame of this report.

Second, still other risks are the result of China’s imbalanced economic growth. China’s neglect of its environment and its public health systems are producing risks of pollution and communicable disease that cannot be easily managed. Similarly, the political strains generated by rapid urbanization and by growing inequality are the inevitable consequences of the development model China has been following for the last 25 years. Even if Beijing successfully changes its economic growth strategy, it will take years to eliminate the negative consequences of these past decisions.

Moreover, although Beijing is trying to mitigate many of these risks, its remedial measures will be difficult to design and, even more, difficult to implement effectively. This will be particularly the case in relation to environmental, public health and economic policies that threaten to reduce the rate of economic growth, which is the highest priority for many local Chinese leaders. Anti-corruption measures will also be resisted by leaders at all levels who are guilty of that crime. And efforts to deal quickly and effectively with environmental incidents and outbreaks of disease may run up against the fear of local officials that to acknowledge these problems is to admit to failures in their own leadership.

Fourth, inaction by the Chinese government – largely because of proscriptions against certain policy options – actually threatens to increase the probability or severity of some of the risks. One example is Beijing’s reluctance to allow the creation of democratic institutions (such as competitive elections, independent NGOs and a completely free press) that could more effectively identify public grievances and official malfeasance. This increases the risk of political unrest and instability, and therefore the reputational risk to foreign firms operating in China. Similarly, Beijing’s bias against private enterprises, particularly their access to capital markets and financial institutions, limits China’s ability to most efficiently utilize its high rate of savings.

Fifth, other risks are the product of Beijing’s quest for comprehensive national power. Beijing’s attempts to promote “national champions,” and more generally to encourage Chinese firms to tap more of the value chain, are increasing the risk of “value destruction” for foreign companies and the risk of a deterioration of the business climate inside China. Similarly, the modernization of the Chinese military, without parallel increases in transparency, somewhat increases the probability that China might initiate an international crisis, and substantially increases the likelihood that other countries will suspect China’s intentions and form some kind of alignment against it. Most generally, China’s attempts to increase its “comprehensive national power” exacerbate the risk of a shift in the regional and global balance of power in China’s favor, if not necessarily hegemony or dominance in Asia.
And finally, efforts by either China or the international community to mitigate some trends may exacerbate others. To list only a few of the trade-offs identified in this regard:

- Political reform, if it involves greater freedom of communication, speech, and organization, could increase the risks associated with popular nationalism.
- Attempts by the major powers to hedge against the rise of China could be misread by Beijing. The resulting mutual mistrust could increase bilateral tensions, and even the risks of an international crisis.
- China’s efforts to enhance energy security by increasing its access to energy resources abroad could increase the suspicions of other major powers with regard to China’s intentions.

As a result of these considerations, the task force has concluded that the probability or impact of most of the risks it has identified will increase over time. (See chart below.)

<table>
<thead>
<tr>
<th>WILL INCREASE OVER TEN YEARS</th>
<th>LIKELY TO REMAIN CONSTANT</th>
<th>LIKELY TO FALL OVER TEN YEARS</th>
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<tbody>
<tr>
<td><strong>HUMANITARIAN PROBLEMS</strong></td>
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<td>Environmental crisis</td>
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<tr>
<td><strong>ECONOMIC PROBLEMS</strong></td>
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<td>Domestic inflation</td>
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<td>Domestic recession</td>
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<tr>
<td><strong>COMMERCIAL PROBLEMS</strong></td>
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<td>Deterioration of business climate</td>
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<td>Disruption of supply chains</td>
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<td>Value destruction</td>
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<td>Commodity inflation</td>
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<td>Reputational risks</td>
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<tr>
<td><strong>POLITICAL PROBLEMS</strong></td>
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<td>Bureaucratic immobility</td>
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<td>Leadership crisis</td>
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<td>Popular unrest</td>
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<td><strong>INTERNATIONAL PROBLEMS</strong></td>
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<td>Transnational crime</td>
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<td>Nationalism</td>
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<td>Bilateral tensions</td>
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<td>Crisis triggered by China</td>
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<td>Polarization</td>
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<td>Shift in balance of power</td>
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<td><strong>ECONOMIC PROBLEMS</strong></td>
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<td>Financial crisis</td>
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<tr>
<td><strong>INTERNATIONAL PROBLEMS</strong></td>
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<tr>
<td>Crisis triggered by others</td>
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There are, however, a few exceptions to this relatively pessimistic generalization:

- The chances of a pandemic are primarily a function of the emergence of a virulent infectious disease. This probability will remain relatively constant over the next ten years.

- Beijing’s attempts to recapitalize China’s banking system, and then to introduce a more rational and stringent credit culture, will gradually reduce both the probability and the impact of a financial crisis.

- The institutionalization of China’s political system will keep the probability and impact of military intervention in Chinese politics relatively low. However, the likelihood and consequences of a political leadership crisis, like other risks, may rise somewhat over the next ten years.

- Despite the increasing risk of popular nationalism, China’s desire to maintain a stable international environment, and the reluctance of other nations to provoke China, will reduce the probability of an international crisis triggered by others, even though the chances of an international crisis triggered by China may increase somewhat in the decade to come.

Connections among risks

An examination of individual risks and an assessment of their relative severity is an appropriate starting point for analysis. But it is not the end of the story. There are significant limits to the degree to which risks can be assessed individually, in isolation from one another. The task force therefore examined the ways in which risks are connected in ways that could increase their cumulative probability and impact. There are an extremely large number of possible combinations of the 21 individual risks identified in this study. But several sets of connections are of particular importance.

First, the possibility that several risks materialize at approximately the same time is of particular concern, especially if their impact is relatively high. Although the Chinese government now has the capability to deal with many risks separately, its financial, organizational and political resources could be overwhelmed if several of them occurred simultaneously. Examples would include the simultaneous occurrence of an outbreak of communicable disease and a severe environmental crisis, or a diplomatic or military crisis at a time of serious trade tensions with the same country.

Second, China’s overall rate of economic growth will also have an impact on the level of risk. In and of itself, a decline in the secular rate of economic growth, which is highly likely over the next decade, might reduce political support for the government, and thus increase the possibility of political unrest. But it would have broader consequences as well. Slower growth would reduce the availability of the financial resources Beijing would need to deal with many of the other risks we have identified, increasing the probability or the severity of the risks or both. It would make it more difficult for China to deal with environmental or natural disasters, halt a pandemic of chronic or acute disease, or prepare for the eventual aging of the country’s population. It might also lead to increased exports and trade tensions with other countries, if Chinese firms sought to find markets abroad to replace the markets that they were losing at home.

Third, the individual risks within some of the five risk clusters could interact in ways that would increase their severity. For example:

- In the economic cluster, a financial crisis, if handled inappropriately, could increase the probability of inflation if the government responded by excessively increasing liquidity, or the risk of recession if the
government responded by increasing interest rates. Conversely, a recession could increase the chances of a financial crisis, if it led to a decrease in asset values or an increase in non-performing loans.

- In the political cluster, bureaucratic immobility would reduce the chances that the Chinese government could deal with social and economic problems in an effective and timely manner. That would increase the probability and impact of popular unrest. A leadership crisis would also increase the chances of significant popular unrest and, conversely, significant popular unrest would increase the likelihood of a leadership crisis. A leadership crisis that could not be resolved, or popular unrest that could not be overcome, would increase the chances of military intervention in politics.

- In the international cluster, significant bilateral tensions between Beijing and the US or a neighboring country would exacerbate popular nationalism in China. This would increase the chances of a military or diplomatic crisis, while simultaneously reducing the Chinese government’s ability to handle that crisis in a flexible manner. The occurrence of a severe international crisis would increase the odds that the international system would polarize into alignments centered around China (on the one hand) and the US or Japan (on the other). And either an international crisis or the process of polarization could cause a shift in the international balance of power.

For a graphic summary of the relationships among the risks in these three clusters, see the chart below.
Finally, risks in one cluster, if they materialize, can trigger risks in another cluster. In this report, these connections are called “risk cascades,” and three of them have been identified. (These cascades form the basis for the narrative scenarios that are appended to the full version of the task force report.)

One such cascade might flow from developments inside China, eventually affecting China’s relations with the international community. For example, severe environmental or health problems could have a serious negative impact on the Chinese economy. Water pollution could harm agriculture and fishing. Water shortages could limit China’s coal production and agricultural and industrial output. Acid rain could reduce crop yields. Air pollution could cause chronic disease in the Chinese work force, reducing its productivity. Specific environmental incidents could require that offices and factories be closed.

Similarly, an outbreak of communicable disease would also have a noticeable economic impact, disrupting both domestic economic activity and international commerce even at an early stage in its spread. For example, the SARS crisis of 2003 caused a significant decline in travel and tourism, and disrupted export industries that depended on face-to-face contact with clients. Efforts to eradicate avian influenza have already interrupted domestic and international trade in poultry, even in the absence of easy human-to-human transmission, and a true pandemic of the disease would have even larger consequences. A quarantine would force the closure of many factories and offices, and much of the country’s transportation infrastructure would come to a halt. Any indication that a communicable virus adhered to manufactured goods would have a severe impact on Chinese exports.

These humanitarian problems could also have direct political consequences. Environmental problems, especially pollution and water shortages, are already the cause of much unrest. What is more, a small but growing network of environmental activists is trying not only to encourage local protests on specific environmental issues, but also to weave them together into a broader national environmental movement.

Public health problems could have similar results. Already, concern with chronic disease has contributed to the growth of the Falun Gong religious movement, particularly among elderly Chinese who do not have access to affordable medical care. If there were an outbreak of an acute communicable disease, the government could be blamed for its inability to prevent an outbreak, or to control its spread. Frightened citizens could overwhelm the nation’s public health infrastructure, demanding vaccination or treatment for the disease, leading to disorder and even violence. If disease spread to the security forces, their ability to deal with unrest would be sharply reduced.

Alternatively, China could experience severe economic problems in the absence of a humanitarian crisis, perhaps as the result of a sudden financial crisis or more chronic trends such as inflation or unemployment. These economic problems, in turn, would increase the risk of political instability, particularly if the government was blamed for the problem or if its response was regarded as ineffective. The risk would be further intensified if the leadership divided over how to deal with China’s internal problems, if that division reduced the government’s ability to deal with domestic issues, and if it encouraged popular protest. A severe domestic political crisis would even increase the chances of military intervention in Chinese politics.

Domestic economic and political problems would increase the risks to foreign businesses operating in China. An economic downturn, severe humanitarian problems, or growing political unrest could all disrupt their supply and distribution chains. This situation would be exacerbated if central or local governments began to tighten controls on foreign business operations. Foreign business might also begin to experience growing reputational risk from operating in a more unstable or repressive China.
A perception of widespread commercial risks would heighten trade tensions, particularly if foreign businesses sought protection or relief from their governments. The same domestic problems could also produce tensions in China’s international political relationships, particularly if the Chinese government were perceived to be suppressing dissent or encouraging nationalism so as to bolster its legitimacy in the face of internal difficulties. Any deterioration in China’s domestic internal situation could increase transnational crime, and could, in the worst case, lead to a significant outflow of migrants or refugees across China’s borders.

The greatest international risk would be produced if, given these mounting domestic and diplomatic problems, the Chinese leadership created some kind of international crisis. It might do so in an attempt to use nationalist sentiment to bolster its waning popular support. Or it might see a crisis as a way of warning foreign countries against taking advantage of China’s internal problems. An international crisis, in turn, would increase the chances of a polarization of the international system into blocs aligned for and against Beijing.

(For a graphic summary of this first risk cascade, see the chart below.)
A second risk cascade would begin outside China. The most likely starting point would be a slowdown in the international economy, as the result of a recession in a major trade partner, a spike in world energy prices, or perhaps a terrorist attack that disrupted international trade. This would reduce the demand for Chinese exports, and the availability of direct or portfolio investment capital for China.

Given the high level of economic interdependence between China and the rest of the world, the deterioration in China’s foreign economic relations could have a significant impact on the rest of the Chinese economy. A reduction in the level of Chinese exports, whether caused by a general slowdown in world trade or by sanctions directed specifically against China, would have a deflationary impact on the Chinese economy, producing slower growth and higher unemployment. So would a reduction in foreign direct investment. If these events triggered a decline in asset prices, they could also lead to a financial crisis, with the prospect of either slower growth, higher rates of inflation, or both.

Alternatively, this risk cascade could begin with a crisis in the diplomatic or military spheres. A military confrontation, whether provoked by China or by another power, would obviously lead to a sharp increase in international tension. Chronic trade tensions could, if unresolved, lead to a downward spiral in Beijing’s diplomatic relations with its trade partners.

Even in the absence of a slowdown in the global economy, mounting international problems such as these could have a significant impact on China’s commercial relations. China’s trade partners could begin to impose sanctions on trade and investment relations with China – tightening controls on technology transfer, raising tariffs on Chinese products, limiting direct investment flows in either direction, imposing restrictions on imports from China, and making it more difficult for Chinese to receive visas to travel abroad. Or the business climate in China could deteriorate because of actions on the Chinese side, whether from formal government decisions to restrict the activities of foreign firms, from informal boycotts or other anti-foreign activities undertaken spontaneously by a nationalistic Chinese population, or from anti-foreign activities by the public that were encouraged by the Chinese government.

As China’s economy slows and tensions with foreign countries mount, the Chinese government could encounter increasing domestic political problems. Divisions within the Chinese leadership over how to handle the challenges might increase. The deteriorating domestic economic situation could trigger protest and instability, and would reduce Beijing’s ability to deal effectively with any environmental or health crises that might emerge. (For a graphic depiction of this second risk cascade, see the chart on the following page.)
A final risk cascade would Ironically begin with positive, rather than negative, developments. It reflects the fact that the international community faces risks that result from a China that succeeds, as well as those that result from a China that fails. This third risk cascade shows that not all good things always go together.

Whether as a result of good luck or effective government policy, China could avoid severe environmental or public health problems over the next ten years. Moreover, a strong international economy, coupled with sound domestic macroeconomic policies, could enable China to continue to grow at impressive (although gradually declining) rates, without significant inflation. The value of the yuan could gradually increase, making it increasingly possible for China to make investments and acquire assets abroad.
This more vibrant Chinese economy would have a variety of consequences for the international economy. On the one hand, China would join the US as a major engine for global economic growth. But, on the other, Chinese economic growth would put greater upward pressure on commodity prices, place greater competitive pressure on foreign firms, and could increase international tensions over trade and investment issues. A more prosperous Chinese economy would also support the more rapid modernization of the Chinese armed forces, and would entail the expansion of China’s commercial and political interests abroad.

If economic prosperity were accompanied by further political liberalization, the result might be increasing popular nationalism, fueled by China’s economic success and its growing military power. This, too, would increase the prospects of a more assertive foreign policy, and would reduce the chances that Beijing could respond flexibly to tensions in its bilateral relationships, let alone to severe international crises.

However, the most likely international consequence from this third risk cascade would not necessarily be an acute international crisis, but rather a gradual shift in the balance of power in China’s favor. China’s sustained prosperity would increase its economic influence; its continued military modernization would bolster its hard power; and its political and economic successes might increase its soft power as well, particularly if accompanied by skillful diplomacy. (For a graphic summary of this risk cascade, see the chart below.)
Recommendations

The risks we have identified can be mitigated if the Chinese government, foreign governments and international organizations, and the foreign business community take appropriate actions. The task force has developed some recommendations of ways of reducing the probability that a risk actually occurs, reducing the impact if it does materialize, or both.

Recommendations for the Chinese government

The Chinese government has acknowledged most of the major domestic risks we have identified in this report, and is developing policies to reduce the chances that they will occur or to alleviate the consequences if they do. The task force finds some of these measures to be of particular importance and endorses the steps that Beijing is taking in this regard.

First, it is vital that Beijing anticipate and plan for the emergence of some long-term issues that may not fully materialize in the time frame covered by this report. In particular, these include the consequences of an aging population and a shrinking labor force. Strengthening China’s public health infrastructure is important not only to reduce the risk of communicable disease, but also to address the health problems that an increasingly elderly population will encounter. Similarly, creating a mechanism for funding China’s future pension and health care burden will provide the social safety net that will be needed as China’s population ages.

Second, it is equally important that Beijing address the impact of its future urbanization and industrialization on environmental protection and energy consumption. The Chinese government will require some retrofitting of existing infrastructure to advance these objectives. But it is even more important, given China’s high levels of growth, that new urban construction advances these same goals. Specifically, urban housing now being constructed should be efficient in the use of energy and water, new manufacturing facilities should be both energy-efficient and environmentally-friendly, new automobiles should use less fuel and produce fewer emissions, and new cities should maximize the use of energy-efficient public transportation.

Third, the further reform of China’s financial institutions – including its banking system, equity and bond markets, and foreign exchange system – will be crucial to dealing with a number of risks considered in this report. A more stringent credit culture will help reduce the irrational level of investment that contributes to economic imbalances, and could help sustain higher levels of growth at lower levels of investment. More vibrant equity and bond markets will allow the efficient investment of pension and medical insurance funds. More fully open capital accounts and a fully floating currency will remove one of the present sources of trade tension between China and some of its major trade partners. And the more efficient use of capital may enable China to enjoy higher rates of economic growth for a longer period of time than would otherwise be the case.

Fourth, China’s emergency management mechanisms need to be improved to deal with environmental and health crises. The country’s experience with the SARS epidemic of 2003, the challenge of avian flu in 2004-06, and the benzene spill along the Songhua River in late 2005, show that more work needs to be done in obtaining accurate and timely information about crises from local officials, taking appropriate action, and communicating with those in society who are potentially affected by the problem.

However well designed Beijing’s solutions to these problems may be, implementing them may prove to be a significant challenge, given the strong interest of local officials in high rates of economic growth to the neglect
of other considerations. One approach is to use market levers, rather than regulatory or administrative mechanisms, whenever possible, to advance policy objectives. For example, it may be more effective to achieve energy efficiency by raising the price of energy, rather than using purely administrative mechanisms to mandate more economical use of energy resources.

But whatever the role of the market, some objectives will necessarily involve administrative action. Effective policy implementation will be increased if incentive structures for local officials are changed to place proper emphasis on environmental protection, energy and water conservation, promotion of education and public health, and other goals beyond economic growth. This will require improved systems for measuring the performance goals by which officials are evaluated. In addition, the central government should ensure that local governments have sufficient revenues to pay for centrally mandated programs, either through authorized local taxes or through revenue transfers. Unfunded mandates are unlikely to be implemented effectively.

Pressures from above for implementation of central policies need to be supplemented by support from below. Responsible non-governmental organizations will play a useful, even essential, role in overseeing the implementation of central policies, and often in providing supplemental social services. The role of non-governmental organizations in Chinese society, including their access to philanthropic contributions, therefore needs to be promoted. So too does an appropriate “watchdog” role for the Chinese press. Experiments should continue to develop mechanisms for providing more public input into government decisions at all levels of the system. Political reforms such as these would also only help the effective implementation of policy, but will also increase the legitimacy of the Chinese government in the eyes of its people, thus reducing the chances of serious political unrest.

Finally, the task force recommends that China take the following steps in its foreign relationships to reduce suspicions and build mutual confidence:

- Moderate the growth of its military capability, linking it in a transparent and justifiable way to real threats facing China.
- Avoid provocative or confrontational actions in relation to the Taiwan issue and other territorial disputes.
- Promote greater cooperation among Chinese national oil companies, international oil companies, and the national oil companies of other major industrial economies in the extraction and production of oil and gas. Transactions in which Chinese national oil companies act alone should be more transparent, and China’s oil companies should be more cognizant of political risk.
- Explore joint development of energy reserves in disputed territories in the South China Sea and the East China Sea.
- Take greater responsibility for the management of major regional and transnational issues, such as nuclear proliferation, terrorism, and the future of North Korea.
- Work through international regimes and institutions whenever possible to advance its national interests.
- Continue dialogue with other major powers, to identify common interests, promote cooperation in achieving common goals, reduce differences in outlook and objectives, and manage any crises that may occur in their bilateral relations.
Recommendations for foreign governments and international organizations

Both Japan and the US are stakeholders in China's future. Their interests are advanced if China can avoid the risks that would be produced by either success or failure. In light of this, Japan and the US, along with other governments and international organizations, can take steps to reduce the severity of some of the risks we have identified, and to protect themselves against others.

- Both foreign governments and international organizations can assist the Chinese government in developing ways to mitigate the domestic risks described in this report. Some financial assistance may be appropriate, especially in dealing with risks in poorer regions of the country. Increasingly, however, the Chinese government has the financial resources to be self-sufficient in this regard. Accordingly, technical and policy advice will be more important than economic aid.

- Foreign governments should also work with China to anticipate and manage the problems that could produce crises in their bilateral relations, and to develop mechanisms to manage those crises if they should occur. In particular, it will be important to find ways of working together to promote alternative sources of energy, increase energy efficiency, ensure adequate supplies of oil and gas, and assure the security of sea lines of communication.

- Foreign governments should cooperate, through international institutions such as the WTO, to ensure China's compliance with international trade and investment norms and with the obligations it undertook to secure membership in the WTO. They should actively convey, both directly with Beijing and through the appropriate international institutions, any concerns about a deterioration of the business climate in China, especially that which involves a violation of China's international commitments to increase market access and provide a level playing field for foreign firms.

- Advanced economies should be aware of China's ability and determination to move rapidly up the value chain, taking advantage of the rapid movement of capital and technology in a globalized world, particularly through foreign direct investment. Maintaining comparative advantage relative to a rapidly modernizing China (as well as other large emerging economies) will be a particularly important part of national economic strategies in the coming years. So will managing inequalities between well paid workers in the globalized sector and poorly paid workers in the domestic service sector.

- Major powers can adopt appropriate hedging strategies to deter any provocative Chinese actions that may be occasioned by the rise of popular nationalism or by increases in Chinese military power. However, they must simultaneously try to avoid triggering a security dilemma, in which those hedging actions are seen as threatening by Beijing. Although it will be difficult to prevent the security dilemma altogether, the risks can be mitigated by providing constant reassurances about intentions toward China, offering full transparency about the nature and purpose of the hedging strategies, and making efforts to bolster cooperation with China in areas of common interest.

- Finally, in addition to hedging against China's growing military capability and maintaining their competitiveness relative to China’s increasing economic strength, countries like the US and Japan will also have to deal with the rise in Chinese soft power, as evidenced in both its cultural appeal and its diplomatic skill. US foreign policy will have to be designed with an eye to competing effectively with Chinese efforts to offer solutions to international problems, define new international norms, and create new international institutions, in ways that run counter to US interests.
Recommendations for foreign companies

Foreign companies receive many benefits from operating in China. China has proven to be an outstanding production platform in terms of cost and quality, a profitable market for selling a variety of goods and services, and increasingly as a research and development base. However, as noted above, these benefits are accompanied by both reputational and operational risks. Some of these can be mitigated through corporate strategies for operating in China. Others can be mitigated by diversifying a company’s sourcing, so that it has sources of supply inside and outside China.

- Like their home economies, foreign companies will have to learn to compete effectively with a rising China – in this case, firms that may become China’s “national champions” in the Chinese market, their home markets, and third country markets. Preserving their comparative advantages in design, production, branding, marketing and distribution will be critically important.

- Growing shortages of skilled labor in China imply that foreign companies operating in China will need to develop and apply effective recruitment and retention policies. Conversely, a possible surplus of college graduates may produce an ample supply for job candidates in this category, but many of them may lack first-rate skills. Foreign companies operating in China can be highly selective, but may have to provide training programs to teach the skills that Chinese institutions of higher education do not teach, and then retain the employees they have trained.

- Given the problems of protecting intellectual property rights in China, foreign firms should be cautious in transferring their most advanced proprietary information to China, or in developing such information there. Retention of Chinese employees who produce valuable intellectual property will be increasingly important.

- Foreign companies operating in China should develop emergency response plans for anticipating and coping with the consequences of epidemics, environmental disasters, natural disasters, and serious political unrest. Such plans should include provisions for evacuation of expatriate staff and shelter for all employees.

- Foreign companies should adopt appropriate corporate responsibility programs to deal with both the operational and the reputational risks inherent in working in China. Foreign companies, however, should not be under any illusions that such policies will protect them entirely from any bilateral tensions between Beijing and their home governments or a deterioration of the general business climate in China.

- Given the risks to supply chains in China, foreign companies should explore ways of diversifying their sources of design and production, as well as avoiding excessive dependence on the Chinese market.
Conclusions

The future of China is fraught with significant risk, both to China and to the rest of the world. As noted in the introduction to this study, some of these risks are associated with failure, while others are linked to success. Some will affect China, some will affect the rest of the world, and some will affect both.

Among the most serious risks to China over the next ten years are those associated with China's environmental and public health problems. They include a crisis in China's polluted physical environment, and an epidemic of a highly infectious and deadly disease. These have both higher probability and higher impact than most other risks the task force examined.

Although the first victims of these two risks would be the Chinese themselves, both an environmental crisis and a pandemic disease could have a far wider impact. Depending on its dimensions, an environmental crisis could have transnational consequences if dangerous air or water pollution were carried beyond China's shores. China's emission of greenhouse gases, for example, could contribute to climate change in ways that would affect the entire planet. Similarly, communicable disease could easily spread beyond China's borders, carried by affected humans or by contaminated animal products, and could conceivably trigger a world-wide crisis.

Other risks that are highly likely to materialize inside China within the next ten years include domestic economic and political problems such as inflation, recession, bureaucratic immobility and popular unrest. The severity of these risks will depend on particular circumstances, especially the size of the shock that triggered them and the effectiveness of the Chinese government's response. Although somewhat less likely, a severe leadership crisis, if it occurred, could have significant consequences, largely by increasing the probability and impact of popular unrest.

To the international community, the most likely risks are, in the near term, inflation in commodity prices (especially energy and minerals) as a result of China's rapid economic growth and, over the longer term, a shift in the international balance of power as China's military, economic and diplomatic capabilities increase. However, the task force concluded that the impact of these developments may not be severe. An increase in commodity prices may be moderate if it triggers an increase in supply or a reduction in demand. And any shift in the international balance of power will be a function of the military strength, economic growth, and diplomatic vitality of other powers, particularly in the Asia-Pacific region.

In contrast, a severe international crisis involving China is not a high risk during the time frame of this study. Given its concern with its domestic problems, and its desire to maintain a stable international environment conducive to continued economic development, Beijing will try to avoid international crises. Similarly, in light of its rising economic and military power, China's neighbors will increasingly respect Beijing's vital interests so as to avoid provoking China. There will always be tensions in China's bilateral relationships, and some of them may occasionally escalate into minor diplomatic crises, especially given the rise of popular nationalism in China. But the mutual desire for stability will help keep those tensions in check. However, if a severe international crisis should unexpectedly occur, and if it could not be managed effectively, the consequences could be severe, perhaps even triggering a long-term polarization of the international system between China and the US.

The international business community also faces significant risks in its commercial activities – risks that, again, may stem either from China's success or from its failure. Firms operating in a troubled China, one characterized by environmental problems, communicable disease, political unrest, or an unstable economy,
would most likely see a disruption of their business operations and supply chains in China and an increase in their reputational risks in their home economies. If China succeeds, those same firms will encounter a different set of risks. In the short run, the Chinese government might adopt a series of protectionist measures to promote “national champions” at the expense of foreign firms. Over the longer run, those national champions could unleash a process of “value destruction,” by which foreign businesses would be forced to compete with Chinese firms that can operate at lower cost.

The task force noted that the risks involving China cannot be analyzed independently of one another. Of particular concern is the possibility that risks will occur simultaneously, overwhelming the Chinese government’s ability to cope with them. This will be a particular problem if China's economic growth rate slows, giving Beijing fewer resources with which to deal with its domestic and international problems. A further danger is that the risks are interconnected, so that if one materializes, it may increase the probability that other risks may occur. There could even be a “risk cascade,” in which problems in one cluster or risks trigger negative developments in other areas as well.

The Chinese government is taking steps to deal with some of the risks. As a result, the task force concluded that some of the risks may become less serious over time. In particular, the chances of a crisis affecting a major Chinese financial institution have already been significantly reduced, the probability of a leadership crisis has declined, and the chances of a military intervention in Chinese politics are low. However, limitations in policy design and problems with policy implementation will limit Beijing’s capability to reduce or mitigate many other internal risks, particularly those associated with bureaucratic immobility and political unrest. China's ability to manage the economy to avoid either overheating or deflation also remains to be tested.

Moreover, even as Chinese policies are reducing the probabilities of some of risks, they are simultaneously exacerbating others. Beijing’s efforts to build China’s “comprehensive national power” are increasing the risks that might come from China’s international rise. These include the prospect that more assertive Chinese foreign policy could trigger an international crisis, and that there could be a significant shift in the balance of power in China’s favor.

Foreign governments, and the international community, can help China mitigate many of these risks, particularly those associated with internal problems. However, the responsibility for managing those risks successfully will rest primarily on the Chinese themselves. The task force urges the Chinese government to design the country’s future urbanization and industrialization to minimize energy consumption and environmental pollution. It also recommends that Beijing develop plans for dealing with the eventual aging of Chinese society, reform its financial institutions so as to make more efficient use of its savings, and find ways of providing incentives to Chinese corporations and local officials to meet social and environmental goals. Political reform will also be an important step in increasing China's ability to respond to political or humanitarian crises, or even to prevent them altogether.

Foreign governments and international organizations can provide technical assistance and policy advice to China as it attempts to reduce the domestic risks described in this report. They should also press China to fulfill its responsibilities as a leading regional and global power and as a major member of the international economy. They need to establish mechanisms for anticipating and managing the problems that could emerge in their relations with China, and for identifying the issues with which they share common interests with Beijing. Working cooperatively to deal with China’s increasing need for energy and other commodities is of particular importance in this regard.
Some foreign governments are, appropriately, adopting policies that they describe as “hedging” against the risks of a rising China. These include strengthening their armed forces, and maintaining the ability to form diplomatic coalitions to counter unacceptable Chinese initiatives. But those same governments should simultaneously take care to avoid the security dilemma, through which efforts intended to counter a perceived security threat from China actually increase it. Hedging strategies could be accompanied by assurances that the international community welcomes China’s emergence as a responsible major power, and that it seeks cooperation and not confrontation with Beijing.

Even more important than hedging, China’s neighbors and other major powers will need to respond more creatively to the prospect of a rising China. They will need to develop policies to ensure that their economies remain dynamic in the face of Chinese competition, and that they are seen as an attractive diplomatic presence both regionally and globally.

Foreign businesses should consider the most effective policies for dealing with the risks emanating from China. Those working inside China will need to develop and maintain effective policies for attracting and retaining Chinese workers and for protecting their intellectual property rights. They should develop emergency response plans for coping with environmental disasters, disease, and political unrest. They will need well designed corporate social responsibility programs to deal with the reputational risks that come from operating in China. Above all, they will need to consider diversifying their supply chains, so that they do not become excessively dependent on the success of their operations in China.

Even firms without operations in China will have to cope with the commercial risks generated by a dynamic Chinese economy. They will encounter rising commodity and energy prices, due in part to increases in Chinese demand. Above all, they will face increasingly effective Chinese competitors, in both their home market and in third country markets. Virtually all foreign firms will be under growing pressure to reduce their costs, increase their efficiency, and effectively define their comparative advantage.