

## CHINA ON VERGE OF JOINING RANKS OF HIGH-INCOME COUNTRIES, WHILE MAINTAINING AUTHORITARIAN REGIME

### THE “GET RICH TOGETHER” DREAM FOR 1.4 BILLION PEOPLE: OPPORTUNITIES AND RISKS FOR FOREIGN CAPITAL

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China's per capita GNI is likely to exceed US\$10,000 in 2019, unless its economy suffers from an accelerated slowdown or the Chinese yuan depreciates sharply. Thereafter, in the first half of the 2020s, GNI could exceed US\$12,236,<sup>1</sup> the level that would classify China as a high-income country by World Bank standards. That will likely spark debate, both domestically and overseas, as to when China will withdraw its stature as "the world's largest developing country," a label it has carried for many years now. Regardless of the direction of such debates, the country will most likely retain its single party-led authoritarian political system. While China is catching up to high-income democratic countries in terms of income, it adheres to a political system that is very different from democratic countries. How should we approach such a country?

#### QUALITY OF GOVERNANCE IMPROVING, BECOMING AN UNPRECEDENTED TYPE OF HIGH-INCOME COUNTRY

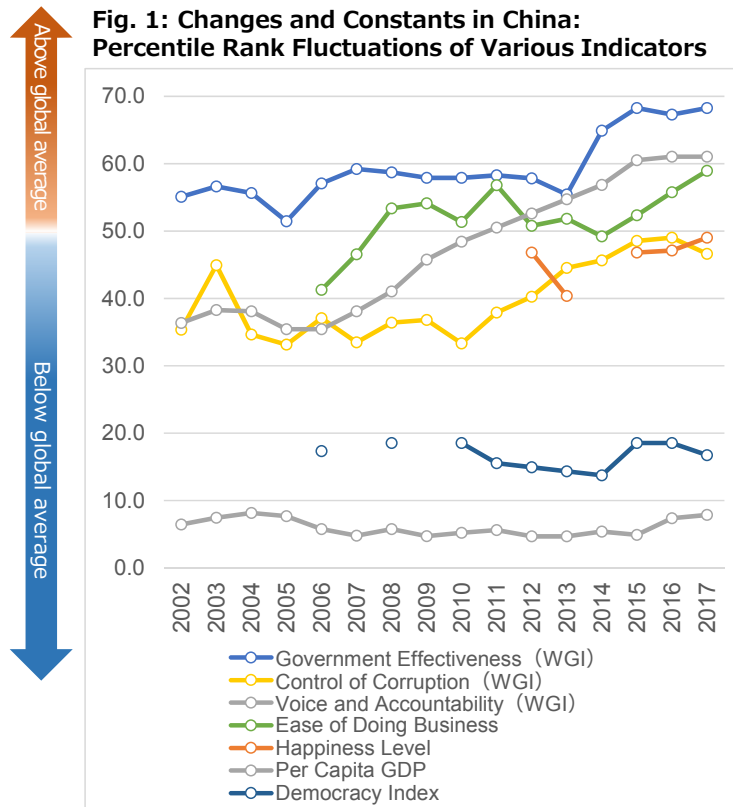
As of 2019, China is considered an upper middle-income country in terms of its economy, while it is an authoritarian state in terms of its political system. Among the changes of recent years, economically, China is heading toward becoming a high-income country. Politically, it is slowly improving the "quality of governance," such as in the area of ability to execute policies, while maintaining an authoritarian regime. This is illustrated in Fig. 1. Percentile rank in Fig. 1 shows the percentage of countries with world rankings lower than that of China for each indicator. If China ranks the highest with respect to an indicator, its percentile rank is 100, while it is 0 if it ranks the lowest. Looking at this, "government effectiveness,"<sup>2</sup> "per capita GDP," and "ease of doing business"<sup>3</sup> are conspicuously trending upward; these indicators for China are now within the top 30% to 40% of the world. "Control of corruption" and "happiness level"<sup>4</sup> are also improving, and are now close to the global averages. Meanwhile, the two indicators related to freedom and democracy have remained almost unchanged, standing under 20% and 10%, respectively.

<sup>1</sup> GNI classifications as of 2016. Middle income countries are further divided into lower middle-income countries (US\$1,006 to US\$3,955) and upper middle-income countries (US\$3,996 to US\$12,235). China's GNI was US\$8,690 in 2017.

<sup>2</sup> One of the six composite measures of the World Governance Indicators (WGI) developed by the World Bank, calculated based on criteria for the quality of public services, the quality of the civil servants and the degree of its independence from political pressures, the quality of policy formulation and implementation, and the credibility of the government's commitment to such policies.

<sup>3</sup> Based on the World Bank's annual ease of doing business index.

<sup>4</sup> Based on the annual World Happiness Report by the United Nations.



Note: Percentile rank for non-WGI indicators calculated based on China's overall ranking out of total number of countries surveyed each year.  
 Source: Compiled by Economic Studies Dept. of Mitsui & Co., Ltd., Beijing Office, based on World Bank's Worldwide Governance Indicators (WGI), United Nations, IMF, and EIU data.

Fig. 2 shows the year-to-year changes in the WGI's six aspects of governance with respect to China. Drawing attention is the increase in scores or percentile rank for "government effectiveness" and "control of corruption" since the government of Xi Jinping came into power in 2012, as well as the increase in scores for "political stability and absence of violence/terrorism" and "rule of law." And as stated above, "voice and accountability," which indicates the degree of political freedom and democratization, has remained at a lower level over the years. The disparity in the trends of these indices could be said to reflect two approaches to governance by the country. On the one hand, the Xi administration has initiated the powerful anti-corruption movement and stronger guidance to local governments in order to step up enforcement of environmental policies. On the other hand, it has strengthened control over freedom of expression by the media, universities, websites, among others, as a means to increase party authority and tighten public morals.<sup>6</sup>

If China achieves the economic level of a high-income country while maintaining the current level of democracy, it will be an unprecedented country in the world. As can be seen in Fig. 3, the leading countries in terms of per capita GNI are almost all democratic countries. Based on 2017 statistics, there were 58 high-income countries,

<sup>5</sup> The score range for each indicator is from a low of -2.500 to a high of 2.500.

<sup>6</sup> Regarding control of information on the Internet, for example, the Cyberspace Administration of China has introduced a special action plan for cyber governance and is strengthening its crackdown on 12 types of what it deems to be harmful information, which are described as or related to the following: 1) obscenity, 2) vulgarity, 3) violence, 4) horror, 5) gambling or fraud, 6) rumoring, 7) superstition, 8) pranks, 9) intimidation, 10) exaggeration, 11) sensationalism, and 12) unhealthy lifestyle and pop culture.

**Fig. 2: Year-to-Year Trends of the 6 WGI Indicators for China**

Paramount Leader	Hu Jintao											Xi Jinping						Comparison between two administrations *
	2002	2003	2004	2005	2006	2007	2008	2009	2010	2011	2012	2013	2014	2015	2016	2017		
Control of Corruption	-0.518	-0.359	-0.560	-0.609	-0.515	-0.590	-0.520	-0.515	-0.562	-0.507	-0.436	-0.358	-0.340	-0.282	-0.254	-0.270	↗	
Percentile Rank	35.4	44.9	34.6	33.2	37.1	33.5	36.4	36.8	33.3	37.9	40.3	44.5	45.7	48.6	49.0	46.6	↗	
Government Effectiveness	-0.060	-0.082	-0.055	-0.120	0.070	0.183	0.151	0.094	0.089	0.088	0.023	0.004	0.323	0.408	0.357	0.422	↗	
Percentile Rank	55.1	56.6	55.7	51.5	57.1	59.2	58.7	57.9	57.9	58.3	57.8	55.5	64.9	68.3	67.3	68.3	↗	
Political Stability, Absence of Violence/Terrorism	-0.327	-0.564	-0.390	-0.502	-0.540	-0.499	-0.491	-0.449	-0.657	-0.602	-0.539	-0.544	-0.523	-0.550	-0.499	-0.251	↗	
Percentile Rank	32.3	28.6	31.6	30.1	28.0	28.0	29.3	30.8	25.6	28.0	28.0	26.5	28.6	26.2	26.7	36.7	⇒	
Regulatory Quality	-0.513	-0.333	-0.309	-0.150	-0.201	-0.172	-0.155	-0.224	-0.234	-0.221	-0.241	-0.288	-0.283	-0.289	-0.264	-0.148	⇒	
Percentile Rank	34.2	43.4	44.3	50.0	48.0	51.0	51.0	45.9	44.5	44.5	44.1	44.1	43.8	44.2	44.2	48.6	⇒	
Rule of Law	-0.498	-0.530	-0.529	-0.589	-0.639	-0.542	-0.420	-0.407	-0.410	-0.465	-0.543	-0.525	-0.414	-0.410	-0.334	-0.263	↗	
Percentile Rank	37.1	34.7	35.9	33.5	31.1	35.4	39.9	42.7	40.8	39.4	35.7	39.0	38.9	39.9	41.3	44.7	↗	
Voice and Accountability	-1.594	-1.512	-1.462	-1.501	-1.749	-1.721	-1.699	-1.701	-1.681	-1.638	-1.638	-1.631	-1.617	-1.661	-1.561	-1.505	⇒	
Percentile Rank	6.5	7.5	8.2	7.7	5.8	4.8	5.8	4.7	5.2	5.6	4.7	4.7	5.4	4.9	7.4	7.9	⇒	

Note: \*Comparison of averages for 2002-2012 vs. 2012-2017. Changes of 5% or less shown as trending flat.

Source: Compiled by Economic Studies Dept. of Mitsui & Co., Ltd., Beijing Office, based on Worldwide Governance Indicators (WGI) data

**Fig. 3: Comparison of Leading Countries by Per Capita GNI and Democracy Index Ranking (2017)**

Rank	Country	Per Capita GNI	Democracy Index (world ranking)
1	Switzerland	80,560	9.03(9)
2	Norway	75,990	9.87(1)
3	Macau	72,050	N/A
4	Luxembourg	70,260	8.81(12)
5	Iceland	60,830	9.58(2)
6	Qatar	60,510	3.19(133)
7	United States	58,270	7.98(21)
8	Ireland	55,290	9.15(6)
9	Denmark	55,220	9.22(5)
10	Singapore	54,530	6.32(69)
11	Sweden	52,590	9.39(3)
12	Australia	51,360	9.09(8)
13	Hong Kong	46,310	6.31(71)
14	The Netherlands	46,180	8.89(11)
15	Austria	45,440	8.42(15)
16	Finland	44,580	9.03(9)
17	Germany	43,490	8.61(13)
18	Canada	42,870	9.15(6)
19	Belgium	41,790	7.78(31)
20	United Kingdom	40,530	8.53(14)
21	UAE	39,130	2.69(147)
22	New Zealand	38,970	9.26(4)
23	Japan	38,550	7.88(23)
24	France	37,970	7.80(29)
25	Israel	37,270	7.79(30)
26	Kuwait	31,430	3.85(119)
27	Italy	31,020	7.98(21)
28	Brunei	29,600	N/A
29	Bahamas	29,170	N/A
30	South Korea	28,380	8.00(20)
69	China	8,690	3.10(139)

Note: Dark green shading indicates "full democracy," light green indicates "flawed democracy," red indicates "authoritarian regime," N/A indicates not covered by EIU survey  
Source: World Bank, EIU

but only 6 of these countries' governments were classified as "authoritarian regimes" according to the criterion of the Democracy Index<sup>7</sup> compiled by the UK think tank Economist Intelligence Unit (EIU), and all of the 6 were Middle East resource-rich countries.<sup>8</sup> It is conceivable that the reason democratization has advanced in many

<sup>7</sup> Countries' political systems are classified based on the weighted average score (out of 10 points) for five indicators, such as electoral process and pluralism, civil liberties, and political culture. The scores are categorized as 8.0 <S ≤ 10.0: full democracy, 6.0 <S ≤ 8.0: flawed democracy, 4.0 <S ≤ 6.0: hybrid regime, and 0 <S ≤ 4.0: authoritarian regime. The lowest score in the 2018 survey was 1.08 for North Korea.

<sup>8</sup> The six countries are: Qatar, UAE, Kuwait, Bahrain, Saudi Arabia, and Oman. In addition, of the high-income countries not covered by the EIU's Democracy Index, Brunei could also be included among those with authoritarian regimes.

of the high-income countries is because democracy is a system befitting the formation of an open, transparent, and lawful market that is essential for stimulating a market economy. Whether China can create such a market environment while maintaining an authoritarian regime will be an extremely important challenge for the Chinese leadership as the country grows economically to soon join the ranks of high-income countries. A stalling of the economy could provoke as much debate over political reform as was witnessed for a while in the 1980s and 2000s, and if the economy cannot be reenergized, the threat to the current system will inevitably arise.

What about the relationship between politics and the economy in China? Last year marked the 40th anniversary since the launch of China's reform and opening-up policies.<sup>9</sup> In a favorable review of these policies, the current administration is presenting the posture of further promoting this legacy, but at the same time, it is also holding on to policies that emphasize the traditional public-owned economy centered on state-run enterprises. Various discussions are ongoing within the administration regarding the balance between the two, and the ideologies and interests of various people with different positions are also entangled here. As such, no clear conclusion has been drawn. However, affected by external pressures which can currently be seen, such as US-China friction, and the partnership of Japan, the US, and Europe on WTO reform, those who advocate market reform and liberalization now have a stronger say. Thus far, as a developing country, China has tried to gain the international community's understanding of its non-market economic policies, such as subsidies for Chinese companies and financial support for state-owned enterprises,<sup>10</sup> but this approach has gradually come to have little effect. Western countries in particular are strengthening their calls for China to exercise the principles of reciprocity and equality.<sup>11</sup> Since China itself is pushing for anti-protectionism and economic globalization, it cannot ignore these calls entirely. China's responses going forward are expected to include progressively accepting private and foreign capital by state-owned enterprises (mixed ownership reform); opening up regulated sectors, mainly service industries, to foreign investment;<sup>12</sup> strengthening protection of intellectual property rights;<sup>13</sup> promoting the liberalization of cross border capital transactions; and further externally promoting the message that China is making changes on all these fronts. China also aims to propitiate foreign countries that are dissatisfied with their trade deficits with China by increasing imports through diplomacy and by hosting the China International Import Expo<sup>14</sup>, while showcasing the attractiveness of the Chinese market. For foreign businesses, although the situation is still far from being fully reciprocal, there is no doubt that these changes will work favorably in expanding opportunities for doing business in China.

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<sup>9</sup> It is recognized that the Chinese economic reform originated at the 3rd plenary session of the 11th Central Committee of the Communist Party of China (held in December 1978), at which Deng Xiaoping emphasized the importance of economic cooperation with foreign countries and greater management autonomy of enterprises, among other issues.

<sup>10</sup> In the discussions on WTO reform, one of the points of dispute is the "special and differential treatment provisions," which allow exemptions and relaxation of duties for developing countries. China, from its standpoint as a developing country, is urging that these provisions be retained.

<sup>11</sup> For example, in November 2018, the German and French ambassadors to China co-authored an op-ed in the Chinese economic magazine *Caixin*, stressing "European businesses should have the same opportunities in China as Chinese industries enjoy in Europe."

<sup>12</sup> China's Special Administrative Measures on Access to Foreign Investment (Negative List), which went into effect in July 2018, clearly stipulates that restrictions on the share of foreign ownership in banks will be eliminated and that such shareholding limits pertaining to securities and life insurance companies will be lifted in 2021. Prospects of relaxing regulations in other service industry fields, such as education, culture, and medicine, are also being debated in the media and other circles.

<sup>13</sup> The draft of a new foreign investment law, which is expected to be reviewed and adopted at the upcoming plenary session of the National People's Congress in March 2019, includes a clause that would ban government officials from using administrative measures to force technology transfers (from foreign companies to Chinese enterprises). The problem of forced technology transfers has been a cause of strong dissatisfaction among foreign companies, mainly US and European companies. In addition to this, China has indicated policies for strengthening penalties against intellectual property infringements.

<sup>14</sup> The concept of the import expo was first revealed by President Xi Jinping at the Belt and Road Forum for International Cooperation held in May 2017. The first expo was held in Shanghai in November 2018. The second expo is scheduled for 2019, also to be held in Shanghai.

## THE MIDDLE CLASS AND SDGS CONNECT CHINA WITH THE REST OF THE WORLD

For the Communist Party of China, the governing goals of "maintaining the system" and "maintaining the stability of the economy and society" are almost synonymous. Therefore, in order to achieve these objectives, the government has undertaken bold reforms in the past that could be called paradigm shifts. Specifically, they are measures to promote a market economy and welcome foreign capital under the leadership of Deng Xiaoping, and the inclusion of capitalists in the Communist Party by former President Jiang Zemin. Without flexibility of this kind, the one-party dictatorial system would have already collapsed, or even if that wasn't the case, China would probably have remained an underdeveloped country even today. Currently, the most important challenge for the Communist Party in ensuring stable governance is to meet the growing needs of the middle class, which continues to expand along with the country's economic growth.

The Chinese Communist Party has set the goal of eliminating poverty in rural areas<sup>15</sup> by 2020, reducing income disparity by 2035,<sup>16</sup> and realizing wealth for the masses (the "get rich together" dream) by around 2049, which will mark the 100th anniversary of the founding of the People's Republic of China. By working to achieve these targets, the party aims to create a nation of 1.4 billion people all belonging to the middle (or higher) class. China is already considered a middle class country at this time. About 80% of all households in China are middle-income households with annual disposable income of US\$5,000 or more, and this figure is expected to approach nearly 100% in 2030, according to EIU estimates and forecasts. In 2017, annual disposable income per household in China averaged US\$11,656; this is a level at which discretionary spending, such as travel, education, and other expenses, increases, and at which demand arises for high value-added services, such as healthcare<sup>17</sup>. As of 2017, average annual household income exceeded the upper middle class standard of US\$15,000 in five provinces and direct-administered municipalities in China (Fig. 4). The addition of Guangdong Province, where average household income most likely exceeded this standard in 2018, would bring the number to six provinces. The combined population of these six provinces and municipalities is 310 million, almost comparable to the population of the US (330 million). Next, looking at 2017 GDP per capita by province (Fig. 5), we find that China has six provinces with levels over US\$12,000,<sup>18</sup> which is around the levels for EU member countries Croatia and Poland. The total combined population of these six provinces and municipalities was about 170 million and their average urbanization rate (living population base, 2017) was 76.4%. These six provinces and municipalities could be categorized as "high-income provinces" when measured against the World Bank's high-income country standards. After these six, four provinces with GDP per capita of US\$9,000–US\$12,000 (total combined population of around 270 million, urbanization rate of 64.1%), which is the level for Russia, follow. Next, in 16 provinces, per capita GDP was US\$6,000–US\$9,000 (total population of some 720 million, urbanization rate of 55.8%), which is a level on a par with Thailand. China's overall urbanization rate was 58.5% in 2017, and is expected to rise to around 70% by 2030. We expect to see the steady emergence of additional "high-income provinces" in China, as expanding urbanization shows the magnitude of growth capacity as a result of urban development investment, change in growth structure, lifestyle changes, etc.

<sup>15</sup> The poverty line in China is defined as annual per capita net income of 2,300 yuan (about 37,000 yen, average within household). The population of people living in rural poverty was 30.46 million at the end of 2017.

<sup>16</sup> The key to narrowing this gap hinges on the Xi Jinping administration's ability to reform asset taxation, specifically whether it can fully implement a property tax and introduce an inheritance tax. If it succeeds, the reform could be described as a paradigm shift.

<sup>17</sup> From a report on consumption trends by income groups by the Ministry of Economy, Trade and Industry. The report looks at strategies for capturing demand from the new middle class and notes that Japan's growth is synced to growth in emerging economies, centered on Asia (July 2012: *Shin Chukansou Kakutoku Senryaku—Asia wo Chushin Toshita Shinkoukoku to Tomoni Seicho Suru Nihon*). The report defines the upper middle class as households with annual disposable income of US\$15,000–US\$35,000.

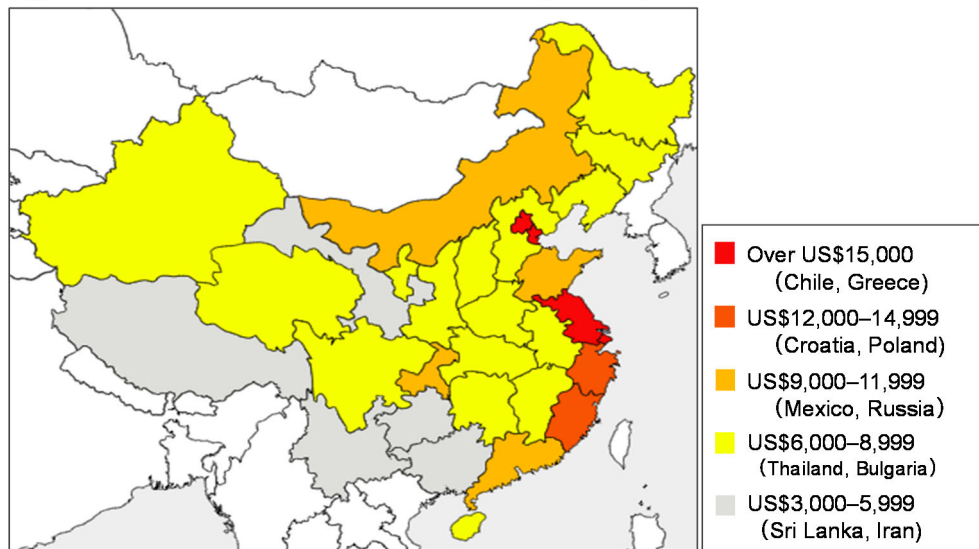
<sup>18</sup> The six provinces and municipalities are: Beijing (US\$19,105), Shanghai (US\$18,755), Tianjin (US\$17,616), Jiangsu (US\$15,869), Zhejiang (US\$13,634), and Fujian (US\$12,245).

**Fig. 4: Top 10 Chinese Provinces by Household Disposable Income (2017)**

		Per Capita Disposable Income (US\$)	Average Household Size	Dispoable Income per Household (US\$)	Population (unit:10,000 people)
1	Beijing	8,476	2.62	22,208	2,170
2	Shanghai	8,737	2.49	21,754	2,418
3	Zhejiang	6,227	2.62	16,316	5,657
4	Jiangsu	5,187	3.09	16,029	8,029
5	Tianjin	5,483	2.74	15,024	1,556
----- Upper Middle Income Line (Household Disposable Income : US\$15,000) -----					
6	Guanddong	4,888	3.05	14,909	11,169
7	Fujian	4,450	3.03	13,485	3,911
8	Hainan	3,340	3.58	11,958	925
9	Jiangxi	3,263	3.64	11,877	4,622
10	Shandong	3,989	2.82	11,248	10,005

Source: National Bureau of Statistics of China, CEIC, People's Bank of China.

**Fig. 5: Classification of China's Provinces by Per Capita GDP**



Note: Countries with similar levels indicated in parentheses.  
 Source: Compiled by Economic Studies Dept. of Mitsui & Co., Ltd., Beijing Office, based on National Bureau of Statistics of China, IMF data.

At important meetings of the Communist Party of China held in recent years, President Xi Jinping has been pressing party officials to step up their efforts toward achieving a “wonderful life” for the people of China. At the foundation of this appears to be the awareness that China has indeed become a middle class country.

What exactly constitutes a “wonderful life”? A pollution-free environment, availability of safe foods, and quality education are some of the requirements. These are consistent with the universal needs of the middle class in any country. Also, the Chinese government has designated the industries for travel, culture, sports, health, and elderly care as “happy industries,” because they are closely associated with promoting people’s well-being, and is advocating consumption in these fields. This could be recognized as an effective growth strategy that addresses the needs of the middle class. There is no great difference in the needs of the middle class in China compared to those of the middle class in Western democratic countries. Moreover, given that the Chinese government is taking measures that reflect an understanding of those needs, the Communist Party of China is really no different from the political parties in democratic countries. On the other hand, due to differences in political systems, when implementing policies for achieving a pollution-free environment, for instance, the costs involved in holding dialogue with industry and society is less in China. So we need to pay attention to the fact that, even if the goal is the same, there are differences in the process for achieving the goal.

While the government’s “wonderful life” campaign is intended to connect with the citizens of China, it is using the Sustainable Development Goals (SDGs) set by the United Nations to show its support and cooperative

attitude to the rest of the world. The SDGs consist of 17 goals, such as “to end poverty in all its forms” and “ensure healthy lives and promote well-being for all,” compiled from a total of 169 targets. As the objectives do not involve issues on which China would likely have difficulty making concessions, such as human rights and its political system,<sup>19</sup> the SDGs could be said to have strong affinity with the administrative challenges that China faces. China’s 13th Five-Year Plan (2016–2020) and other prominent reports incorporate the goals of the 2030 Agenda of the United Nations, the core of which is the SDGs, and President Xi Jinping also often speaks on the topic of SDGs in meetings with other leaders of the world. However, in China’s actual economic cooperation with foreign partners, it is hard to say that it is being duly respectful of the SDGs under the present circumstances, except for cases like the Asian Infrastructure Investment Bank (AIIB) that involve the participation of various Western countries, which enables multilateral promotion of the goals. In addition to the problems of environmental destruction and corruption attributable to China in partner countries, criticism is recently mounting, especially in the US, that China’s Belt and Road Initiative is effectively a “debt-trap diplomacy.”<sup>20</sup> As severe criticism grows louder, China is working to refine its economic cooperation with foreign countries in a bid to maintain the centralizing energy of the Belt and Road Initiative. Strengthening partnerships with developed countries toward achieving the SDGs, such as the joint efforts currently underway with Japan for promoting business cooperation in third country markets, is part of this attempt. So for industrialized countries, it could be said that the various types of projects in third countries that leverage China’s capital and manufacturing capabilities present an increasingly promising business model.

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## **FREEDOM AND DEMOCRACY: DIFFERENCES IN PERCEPTION REMAIN UNRESOLVED**

Meanwhile, China and developed countries do not share common goals on certain topics. Namely, on human rights and democracy. With respect to human rights, China, too, places importance on social rights, such as the right to life and the right to education, in consideration of social stability, but it sets various restrictions on freedom, such as freedom of expression, freedom of religion, freedom to live where one chooses and to relocate. There is a big difference in China’s thinking on the issue of freedom compared to Western democracies. When asking why China downplays the importance of human rights and democracy and strengthens control over religion,<sup>21</sup> from the viewpoint that “the Communist Party of China governs by placing importance on the needs of the middle class,” the following two hypotheses emerge. The first is that the majority of China’s middle class do not feel they are being suppressed under the current regime and thus do not place much emphasis on human rights and democratic issues. A second explanation could be that because democracy and religion are considered risks that threaten the stability of Chinese society and the system, those matters are strictly managed by the party, regardless of the middle class’ perception to these aspects.

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<sup>19</sup> With respect to human rights, the SDGs target social rights-related issues, such as “eliminating extreme poverty” and “abolishing forced labor,” but do not include those related to freedom, such as “freedom of expression” and “freedom to choose where to live and relocate,” which most would say China does not guarantee sufficiently.

<sup>20</sup> After extending financing to a partner country for overseas projects, which makes the partner country debt-ridden, if the partner then faces difficulty repaying the debt China moves to acquire management rights to infrastructure assets of investees. US Vice President Michael Pence delivered a speech, entitled “Remarks on the Administration’s Policy Towards China,” at a Washington think tank on October 4, 2018, in which he criticized China, citing its loans to Sri Lanka and Venezuela as examples. The fact that China is not yet a member of the OECD, which sets out the principles and guidelines for foreign aid, and the Paris Club, which coordinates interests among creditors to find solutions, also gives the developed Western countries reason to criticize China’s economic strategies involving foreign partners.

<sup>21</sup> The United Nations, international human rights groups, and overseas media covering Chinese issues have been voicing criticism of China’s compulsory detention of ethnic minorities in so-called re-education camps in the Xinjiang Uygur Autonomous Region (XUAR), and its intensifying suppression of unregistered Christian churches in various regions, among other developments in China. Since China enacted the revised Religious Affairs Regulations in February 2018, local authorities have been cracking down on control of religious activities.

An EIU report issued in November 2018 on the results of an international survey of citizens<sup>22</sup> could be interpreted as evidence, albeit indirectly, supporting the first hypothesis. In the survey, which looked into how citizens feel about the state of their societies, the percentage of respondents in China who said they were “content” with the way the country was being run, and who believe their country is moving towards a better society in the next 10 years was 70.2% and 91.4%, respectively, both of which were the highest of the 50 countries surveyed. Regarding religion, according to a survey conducted by a US think tank in 2015, in answer to the question: “How important is religion in your life?” only 3% answered that it was “very important,” which was the lowest of all countries covered in the study.<sup>23</sup> I find this data possibly proves both of the above hypotheses. Currently, human rights and democracy have not become widespread interests of the Chinese people to the extent that the Communist Party cannot control their direction, but we could say that the party’s current measures are aimed at preventing this from happening in advance.

The Chinese government’s attitude of downplaying human rights and democracy issues is also presenting itself in China’s foreign diplomacy. For example, when Beijing hosted the Forum on China-Africa Cooperation (FOCAC) in September 2018, President Xi Jinping pledged that China’s cooperation with Africa would be based on its “five nos” policy. The five principles include: no attachment of political strings to assistance to Africa, and no interference in African countries’ pursuit of development paths that fit their national conditions.<sup>24</sup> Looking at the EIU’s Democracy Index (2018) by region, the Middle East/North Africa had the lowest score (3.54), followed by Sub-Saharan Africa (4.36). Only these two regions had scores that were 1.00 or more points below the world average (5.48). As cooperation with Africa based on China’s “five nos” would reduce the influence of Western countries that are trying to promote human rights and democracy in Africa through “conditional economic cooperation,” the Chinese government’s attitude on these issues has become a cause of friction. China seems to be consciously shifting its position on SDGs and human rights, depending on the context—either it is a case of unilateral economic diplomacy, or cooperation with developed countries (companies) in third country markets. But, in the latter case, foreign companies need to be wary of becoming affected by and caught up in China’s “primary” diplomatic stance that can be usually seen when China is pursuing unilateral diplomacy.

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## FOREIGN INVESTMENT OPPORTUNITIES INCREASING, BUT THREE POLITICAL RISKS WARRANT ATTENTION

China’s is composed of a huge middle class, which is the same in nature as the middle classes of developed countries, who also aspire to live “a wonderful life,” with a structure which is quite different from that of developed countries, and that will not change over the long term. If we keep our eye on the middle class, we will see it continue to expand and income levels will rise further. In addition, business opportunities for foreign investment are certain to increase steadily, propelled in part by the momentum of China’s further opening up to the outside world. Meanwhile, the fact that China maintains a system that is not in harmony with the rest of the world, and as such, foreign countries’ wariness against and discontent with China are growing, is a risk to foreign companies’ business concerning China. This manifested in 2018 in the form of the US-China trade war. The US is tightening regulations on not only trade, but also on Chinese investment in the US and technology transfers from the US to China,<sup>25</sup> as well as excluding Chinese equipment from US government procurements, thereby

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<sup>22</sup> The Priorities of Progress survey covered 3,211 citizens in 50 countries.

<sup>23</sup> Conducted by Pew Research Center in spring 2015. For the 40 countries covered by the survey, the percentage of people who responded “very important” to this question averaged 58%. The highest was 98% for Ethiopia, the US at 53% ranked 20th of all countries polled, and Japan at 11% was the second lowest after China.




<sup>24</sup> The other three are: no interference in African countries’ internal affairs; no imposition of our will on African countries; and no seeking of selfish political gains in investment and financing cooperation with Africa. In Xi’s speech, he also called on all countries with ties to Africa, not only China, to address the problems in Africa based on the “five nos.”

<sup>25</sup> For example, the Foreign Investment Risk Review Modernization Act of 2018 (FIRRMA), which was established in August 2018, includes measures to strengthen oversight of foreign investment in US companies that have advanced technologies and to mandate reporting of transactions involving foreign governments. Although the measures apply to all foreign investments, it is clear that they were



extending the reach of its “battle lines.” Its impact is also spreading to businesses in third countries. US allies, including Japan, are working to coordinate with the US on its initiative to hold China in check. For businesses in those countries, not only is it important for them to rearrange their supply chains that involve the US and China, but also they are entering a phase that analyzing and responding to comprehensive risks are necessary. The political risks to foreign companies’ business involving China can be divided into the following three categories. (1) US’ containing measures against China: Measures by the US and its allies, such as for excluding certain Chinese companies from the market or tariff sanctions applying to China as a whole, are forcing foreign companies to change their Chinese partners and to rearrange their global supply chains. (2) Laws and policies specific to China: We refer in particular to cyber security laws.<sup>26</sup> Such regulations push up business costs for foreign-funded enterprises, or those foreign companies may face backlash from stakeholders outside of China if they are too accommodating the demands of Chinese authorities. Especially needing scrutiny are China’s laws and policies that overlook human rights and democracy, such as social surveillance and information control measures. (3) Boycotts in the Chinese market: Products and services may be boycotted due to worsening of relations between the governments of China and the countries of the foreign companies. Anticipated risk scenarios and industries vulnerable to the impact of boycotts are summarized in Fig. 6.

**Fig. 6: Three Political Risks for Foreign Companies Doing Business with China**

Type of Risk	Possible Risk Scenarios	Particularly vulnerable Industries	Outlook for Expansion of Risk
<b>(1) US Containing Measures Against China</b>	<ul style="list-style-type: none"> <li>-In the US market, businesses of foreign countries using the products of specific Chinese enterprises will become subject to review.</li> <li>-Foreign companies will not be permitted to sell off US-held assets to Chinese entities.</li> <li>-Foreign companies will not be allowed to sell products using US companies' components (including technologies and patents) to Chinese enterprises.</li> <li>-Foreign companies will be forced to replace existing US-China supply chains, in part or in full.</li> </ul>	Manufacturers, telecommunications carriers, trading companies, etc.	
<b>(2) Laws and Policies Specific to China</b>	<ul style="list-style-type: none"> <li>-In accordance with Chinese laws and regulations, restrictions will apply to foreign companies on the transfer of domestically collected data out of China. They will also be required to disclose data upon request by the authorities.</li> <li>-In line with the Chinese government's goal of increasing the domestic production ratio of high-tech products, and also in response to the requests of Chinese customers, foreign suppliers will be forced to set up production bases in China and to promote technology transfers to China.</li> <li>-Foreign suppliers of goods and services (surveillance camera parts maker, Internet search services companies, etc.) related to policies of concern among the international community, such as building a social surveillance system in China, will become subject to criticism from the viewpoint of ESG and other considerations.</li> </ul>	All industries	 (Laws and policies that create difficulties for foreign companies carry the risk of causing foreign capital to “leave China,” and the authorities, therefore, would enforce the regulations rather cautiously.)
<b>(3) Boycotts in the Chinese Market</b>	<ul style="list-style-type: none"> <li>-The Chinese government, businesses, and consumers will boycott the goods and services of foreign companies sold in China, either openly and intensely or quietly.</li> <li>-Fewer Chinese tourists will visit certain countries, or the authorities will direct travel agencies to encourage that trend.</li> </ul>	All industries, especially businesses that provide consumer-oriented products and services that characterize the country. Automobiles for Japan, mobile phones (iPhone) for the US, etc.	

Source: Compiled by Economic Studies Dept. of Mitsui & Co., Ltd., Beijing Office.

Regarding (1), although some aspects of US-China friction (for example, trade disputes) may reach a temporary lull, it is inevitable that the rivalry overall, which includes technology supremacy and disagreement over the Taiwan, will be extended over the long term. There is strong possibility that this type of risk will heighten, and this warrants attention. On the other hand, it will probably become just as important to be able to identify business opportunities amidst the change in the landscape caused by the friction. For example, in response to the pressures of US-China friction and decelerating growth, China is further promoting its opening up policies

formulated in consideration of the need for tighter control against the countries that pose security threats to the US, specifically China and Russia.

<sup>26</sup> Enforced from June 2017, the regulations mandate that certain data be stored on local servers in China and restrict transfer of such data across borders.

and strengthening the protection of foreign investment rights, as well as working to correct the trade structure,<sup>27</sup> and these are creating new foreign investment opportunities. In fact, despite increasingly stormy US-China relations, US companies are pushing forward with large-scale investment in China. Examples include Exxon Mobil's decision reached in August 2018 to construct an LNG receiving terminal in Guangdong Province, and the construction start of Tesla's first overseas EV factory in Shanghai in January 2019. It could be said that these US companies, which one would assume have high exposure to risk because of China's discord with the US, have taken such moves to avoid missing out on expanding business opportunities (arising in part as a result of the friction) because they still view the Chinese market as exceptionally promising.<sup>28</sup>

China, which is striving to achieve its "get rich together" goal for its population of 1.4 billion people, will surely remain the world's most important market over the long term. Even if the Chinese economy were to stall in the short run, the possibility of it falling into a long-term recession is low because the living urban population will continue to increase by at least around 10 million a year, at least through the 2020s before China becomes a super-aged society, underpinned by people's robust consumer confidence as they aspire to achieve "a wonderful life."<sup>29</sup> In addition, the Communist Party is not in a position where it can risk allowing the economy and society to become unstable, for example by permitting nationalism to heat up the friction with the US more than necessary, because the party must ensure a stable lifestyle for the expanding middle class. For foreign investors seeking to grow their business on a global scale, excluding China would be a major loss of opportunity. If they are overly cautious about political risks, it will be difficult to capture the benefits of China's growth. So if choosing to "not exclude China," then, in addition to standard risk management, foreign businesses should adopt a proactive approach after clearly determining which political risks should be avoided and to what extent.

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<sup>27</sup> For example, to show a conciliatory attitude towards the US in bilateral trade negotiations, China agreed to expand imports of energy and food from the US, but it is also trying to increase imports of the same products from Russia and Central Asia.

<sup>28</sup> Tesla (Shanghai) Co. Ltd. is wholly owned by Tesla Hong Kong Co., Ltd. Since 2018, independent management of EV manufacturing operations in China is permitted. Exxon Mobil is expected to export LNG from Papua New Guinea and Mozambique to China. Even if China's retaliatory tariff on LNG imports from the US is extended, the impact could be avoided, and Exxon Mobil's price competitiveness would increase by the amount of the tariff that would apply to another company's US-produced LNG.

<sup>29</sup> A society in which the proportion of the population aged 65 or over accounts for 21% or more of the total population. China is expected to reach this level in the mid-2030s.