

GRS 400

CONFIDENTIAL

CONFIDENTIAL

FM PEKING

TO ROUTINE FCO

TELNO 003

OF 020745Z JANUARY 86

INFO ROUTINE HONG KONG, WASHINGTON, TOKYO, MOSCOW

AMENDED DISTRIBUTION
3-1-86

W

CLOUDS OVER CHINA

1. THE TIMES LEADER OF 28 DECEMBER WILL HAVE BEEN WIDELY READ AT HOME AND HAVE ATTRACTED THE INTEREST OF MINISTERS. I THINK IT GIVES A MISLEADINGLY GLOOMY IMPRESSION OF CHINA'S PROSPECTS.
2. I AGREE THAT CHINA'S EXPERIENCE WITH ITS REFORM PROGRAMME HAS NOT BEEN ENTIRELY HAPPY DURING 1985. THE ECONOMY BECAME OVERHEATED AND PRICE REFORM PROVED A CHASTENING EXPERIENCE. BUT THE FACT REMAINS THAT THE CHINESE LEADERS FACED UP TO THESE PROBLEMS AND TO A GREATER OR LESSER EXTENT DID SOMETHING EFFECTIVE ABOUT THEM. MORE IMPORTANT, THEIR COMMITMENT TO REFORM REMAINS UNALTERED, DESPITE THE DIFFICULTIES AND DESPITE THE DOUBTERS WITHIN THEIR OWN RANKS. THE PARTY MEETINGS IN SEPTEMBER ADOPTED GUIDELINES FOR THE SEVENTH FIVE YEAR PLAN (1986-90) THAT WERE THOROUGHLY REFORMIST IN INSPIRATION. I HAVE NO DOUBT THAT THE SPIRIT OF THESE GUIDELINES WILL BE REAFFIRMED WHEN THE PLAN IS FIRMLY INAUGURATED LATER THIS YEAR. SIMILARLY, THE OPEN DOOR REMAINS OPEN. CHINA WILL HAVE A DEFICIT ON TRADE ACCOUNT FOR 1985, BUT IT WILL NOT BE ON THE SCALE PREDICTED BY THE IMF OR HINTED AT IN THE TIMES LEADER. ON A POINT OF FACT, CHINA'S FOREIGN EXCHANGE RESERVES ACTUALLY BEGAN TO RISE IN THE THIRD QUARTER OF LAST YEAR.

CONFIDENTIAL

3. THE REFORM PROGRAMME OF THE PRESENT CHINESE LEADERSHIP IS UNLIKE ANYTHING ATTEMPTED BEFORE IN CHINA OR ELSEWHERE, AS THE LEADERSHIP HAS FOUND, SUCH LEAPS IN THE DARK ARE ACCOMPANIED BY PITFALLS, PERHPAS MORE THAN THEY HAD ANTICIPATED. THE REFORM PROGRAMME HAS NOW BEEN GOING ON FOR SEVEN YEARS AND HAS LOST SOME OF ITS INITIAL APPEAL DESPITE THE VERY REAL ACHIEVEMENTS TO ITS CREDIT. PEOPLE'S EXPECTATONS ARE NOW HIGHER. AT THE SAME TIME, A DELIBERATE RELAXATION OF SOME OF THE RIGOURS OF THE SELF-POLICING STATE HAS GIVEN PEOPLE AN OPPORTUNITY TO EXPRESS THEIR DISCONTENT MORE FREELY. I DO NOT FORESEE AN EASY PATH FOR CHINA. BUT THE FACTORS FOR CONTINUITY OUTLINED IN THE LAST THIRD OF THE LEADER OUTWEIGH IN MY MIND THE THREATS TO STABILITY POSED BY THE UNDOUBTED DIFFICULTIES THE CHINESE HAVE ENCOUNTERED. FURTHERMORE, THERE IS NO FIGURE COMPARABLE TO MAO TO RALLY OPPOSITION TO THE REFORM PROGRAMME OR TO FORMENT DISCONTENT.

4. I WILL BE COVERING ALL THESE ISSUES AT GREATER LENGTH IN MY ANNUAL REVIEW.

EVANS

LIMITED
FED
HKD
NEWS D
INFO D
PLANNING STAFF
TRED
R D
FUSD
ECONOMIC ADVISERS
PS
PS/LADY YOUNG
PS/MR RENTON
PS/MR EGGAR
PS/MR RIFKIND
PS/PUS
CHIEF CLERK
MR DEREK THOMAS
SIR W HARDING

MR GOODALL
MR FERGUSSON
MR BRAITHWAITE
MR DAUNT
MR WINCHESTER
MR JOHNSON
MR BARRINGTON
MR RENWICK
MR SAMUEL
MR MAUD
MR O'NEILL
MR WILSON
MR DAVID THOMAS
MR MACINNES
MR LONG

COPIES TO:-
EAD/ODA
MR PEIRCE ASSESSMENTS STAFF
CABINET OFFICE
DI4 MOD
SEC(O/C) MOD
SEC(D SALES) RMD3 MOD
OT2/3 DTI
PEP DTI
MEE DTI
RTP DTI
MR DEADMAN (EU) D/TRANSPORT
DR FISK D/ENVIRONMENT
SIR P CRADOCK NO 110 DOWNING ST.
PS/MR CHANNON DTI
PS/LORD YOUNG D/EMPLOYMENT
PS/MR JOPLING MAFF
PS/MR RIDLEY D/TRANSPORT
MR UPTON DHSS
MR ORME MAFF
PS/MR BRITTAN DTI

PS. NO 10 D.ST.

-2-
CONFIDENTIAL



P.O. Box 7, 200 Gray's Inn Road, London WC1X 8EZ. Telephone: 01-837 1234

CLOUDS OVER CHINA

This time last year, China's well-wishers were quietly confident. After nearly a century of turmoil, the country seemed at least to have settled down to becoming a modern state. Its economy had sprung to life, and its political leaders had one over-riding priority: to raise living standards.

Now, such confidence looks, if not misplaced, then premature in the extreme. China goes into 1986 less assured and less united in purpose than it was only 12 months ago. Its reform programme which survived a difficult birth seven years ago is now once again at risk. Its open door on the world, flung wide last year, is swinging perilously.

China's problems are legion. Its economy, which was boosted in 1985 by the further relaxation of controls and easy foreign credit, is overheating. Inflation is running - according to official Chinese figures - at an annual rate of over eleven per cent. Many food prices have risen by fifty per cent or more. Capital investment has been over-stretched, and building projects all over the country are being halted for lack of funds. Imports of manufactured goods, bought largely on credit, have flooded into the country from Japan and Hong Kong, and China's foreign currency reserves have fallen at an alarming rate.

In the countryside, where eighty per cent of China's population still lives, the effects of decentralization and a limited market economy are working themselves out. Grain production fell slightly this year for the first time since the reform programme began in 1978. And peasants, who have been keen competitors in the race for self-enrichment, are choosing to plant cash crops for profit rather than grain for the state. By now, productivity has increased about as far as it can without more advanced farming methods. But universal provision of modern machinery and chemical fertilizer is a distant prospect. The pace of rural reform has outstripped the pace of industrial development, and the two will be out of step for some time to come.

As the initial stimulus of the reforms has begun to wear off, so have many of the hopes they generated. What is left is resentment and deep social divisions. The impoverished peasants of the barren mountain interior now see less hope of catching up with the rich of the fertile southern valleys. The young unemployed, described euphemistically as "waiting for work", now see little prospect of matching the successful urban entrepreneur - not by legal means, anyway. And foreign visitors and their possessions inspire little but envy - envy which has erupted over the past year in occasional violence.

Everywhere, expectations

have been raised: for a car, for a television set, for a wristwatch. But those expectations have not and cannot be met - at least not yet, and not for every one of China's 1,000 million people. Some have turned to extra-legal means; others to outright corruption, and webs of vice have been unravelled which lead back to senior Communist Party men or military officers. The days when either group was a model of probity and honour are gone.

Developments such as these have left China's political leaders confused. They are less certain now than they were that raising living standards is by itself enough; or even that it is possible given China's poverty and diversity. Open divisions have emerged within the leadership between those who blame the reforms - decentralization, the freer market and the open-door policy - for China's current difficulties, and those who blame the piecemeal way in which they have been introduced. There has been an uneven, and uneasy, retrenchment. The urban reform programme (which generated such confusion over the past year) has been slowed down. New restrictions have been imposed on foreign credit arrangements; import quotas have been cut.

Deng Xiaoping, the architect and pioneer of the reform programme and a staunch believer in the possibility of raising living standards throughout China, has stood his ground. But even he has occasionally cast doubt on the permanence of his policies, causing a shudder to run through the country's Special Economic Zones and Hong Kong, not to speak of China's foreign trading partners. At the end of 1985, the balance of China's future is very delicately poised, and the risks of a complete about-turn must not be underestimated.

In some quarters, the slowing of the reform programme has been welcome. Many communists of the older generation would like it abandoned altogether; they regard its pursuit of material wealth as the source of corruptibility in China today. And many others would subscribe still to the twin values of asceticism and egalitarianism: the older generation who grew up amid the deprivation of the civil war; large sections of the military who have held fast to the old values and seen their political influence lost to the technocrats. There are also the have-nots of the new generation - the rural and urban poor, and the students, who have watched their living standards decline and their career prospects restricted.

Twenty years ago, it was the alliance of just these forces which unleashed the anarchy of the Cultural Revolution, and something similar could happen again. The angry demonstrations seen this year - against foreign

sportsmen, against the Japanese, against poor living conditions - showed how close to the surface such passions run.

But there are good reasons why, with care, the events of twenty years ago should not repeat themselves. In the past decade, the face of China's countryside has changed beyond recognition. Once neglected landscapes are carefully planted and watered; new houses are being built. And even with this year's smaller harvest, China is still self-sufficient in grain - a major achievement for a country as undeveloped and populous as China. The cities are better supplied, and urban commerce is thriving; and while industrial development has fallen behind what was planned, an industrial infrastructure is taking shape. Too many people now have a stake in China's development to make a reversal of policies easy.

At the same time, China has avoided the major pitfalls of less advanced economies: it has not neglected agriculture for the sake of excessive industrialization, nor has it been relegated to a raw materials base for the developed world.

China also has certain historical advantages which help to underpin its modernization policies in a way that the extremes of Maoism were never underpinned. It had, before the communists came to power, a well developed network of commercial exchange between town and county based on its provincial centres, and a tradition of successful trading. How durable this tradition was has been illustrated by the speed with which it has revived in recent years.

The dogmas of Maoism, though not fifty years old, are already being subordinated gradually to the requirements of the mid-1980s. And China has another advantage, too. It has retained a sense of its own dignity - superiority even - which allows it to take its place on the international scene, un beholden to any and free of the dangerous paranoia that has so afflicted the foreign policy of the Soviet Union.

But the greatest deterrent to change in China's current policies is the experience of the cultural revolution itself, which is still within living memory. As that memory fades, however, the risk of a reversal will increase. Despite Deng Xiaoping's best efforts, the continuation of his policies is not yet guaranteed after his death. His opponents are ready and waiting to take over. Any deterioration in China's economic position will make their task easier. In the long term, the very long term, the omens for a prosperous, powerful and responsible China are favourable. But the greatest risk at the moment is that we treat China as a stable country. It is not.