China, Taiwan, and India, Dec 2002

❖ China and Taiwan cooperate much more than people usually realize.

❖ India has been making big changes, too. But China has faster economic growth and India is worried.

❖ There is a story about an Indian businessperson who visits China.

❖ China, Taiwan, and India are dealing with a lot of different issues.

❖ There are 7 stories and 20 pages here.
Taiwan and China

In search of the missing links

TAIPEI
On-and-off talks about phones and planes

SLOWLY, Taiwan and China have been moving towards an agreement that would establish direct business, communications and transport links between the two countries, ending a ban that dates back to China's Communist revolution of 1949. Or at least they were, until this month. Nothing in the world of China-Taiwan relations is ever easy.

Hopes for the ending of the ban were kindled a year ago when Taiwan's President Chen Shui-bian asked the country's business and political elite how to get Taiwan's economy, hard hit by the global slump, back on its feet. They overwhelmingly asked for the ban to be lifted. Early in the 1990s, China, an international pariah after the Tiananmen clampdown, had desperately wanted the ban lifted but Taiwan said that, in return, China should recognise its government as one of equal status, and renounce the use of force to resolve differences between the two countries. China said no, and by the end of the decade, now richer and more confident, it no longer needed Taiwan so badly.

Taiwan, though, seeing its American markets in free-fall and challenged by China's technically-skilled and ludicrously cheap workforce, began to woo the Chinese. Chinese officials said that any progress on direct links depended on Taiwan agreeing that it was actually a part of China, a claim that over the years the Taiwanese have parried. In May this year, Mr Chen suggested a "Hong Kong" solution over business links. Although Hong Kong is now Chinese, it has some freedom to negotiate independently. It agreed to direct air links with Taiwan through a deal made by business people representing the airlines of the two territories, renewing an arrangement that existed when Hong Kong was British. Government officials acted only as "advisers".

At first the Chinese turned down Mr Chen's proposal that the same idea could be applied to direct links with China itself. But in June Qian Qichen, a Chinese vice-premier, spoke favourably of letting business associations negotiate for each side. In mid-October Mr Qian said that recognition of the "one China" principle was no longer a condition for negotiations and that such links would not be judged "domestic", which would imply that Taiwan was part of China. But Taiwan has changed its mind. Mr Chen now says that there must be government-to-government talks. With Taiwan's economy looking better, Mr Chen is less desperate.

The latest variation on the air-links theme, suggested by opposition MPs, is to allow direct cross-strait charter flights during the Chinese new year, to shorten the journeys of Taiwan businessmen in China coming home for the holiday. Fine, said Taiwan's government, as long as they are routed through Hong Kong, making them, of course, not direct flights at all. Nevertheless, direct links are still being talked about, and talked about...
India Slips Far Behind China, Once Its Close Economic Rival

By KEITH BRADSHIER

SONEPAT, India — Raj K. Gupta, a partner in one of India's largest shoe manufacturers, makes a dreaded but necessary trip every two months to Hong Kong and then into Guangdong Province in southern China.

He goes to buy Chinese shoe-making machinery, because India has few producers of such machinery.

He goes to purchase Chinese synthetic leather, because India makes little of the material and most of that is of low quality.

He goes to visit Chinese shoe factories, to draw lessons from their enormous size, advanced technology and highly organized operations.

When he is done, after eating too much Chinese food, which he dislikes, he flies home and thinks about how India, despite democracy, has fallen behind China, a one-party state struggling with the aftermath of Communist economic policies.

"If we were more developed here I wouldn't have to go so much," he groused, sitting in his office, where incense burned in a corner before a group of paintings and statues of Hindu gods. "We should have that kind of technology, both for our international competitiveness and for our domestic market."

India's continued backwardness compared with its neighbor across the Himalayas has become a national obsession. The world's two most populous countries, China and India were close economic rivals just two decades ago, each struggling to bring progress to vast numbers of impoverished peasants.

But now China, by quickly converting much of its economy to an unfettered and even rapacious version of capitalism, has surged far ahead. The average Chinese citizen now earns $890 a year, compared with $460 for the typical Indian, according to the World Bank.

Only slightly more numerous than Indians these days, Chinese citizens now buy one-third more cars and light trucks each year, 3 times as many television sets and 12 times as many air conditioners. China has high-speed freeways, modern airports and highly efficient ports that are helping it

Continued on Page A10

A shoe worker in New Delhi works with Chinese synthetic leather. India is obsessed with its backwardness compared with China.
India Falls Behind as China Steps Up Economic Growth

Continued From Page A1

dominate a growing number of manufacturing industries.

India's potholed roads, aging airports and clogged ports make exports difficult. China attracted as much foreign investment last month as India did all of last year.

Some blame India's lagging performance on the country's stifling bureaucracy, although many market-limiting regulations have been lifted since New Delhi began dismantling its "license raj" in 1991.

Some blame the country's cultural and religious traditions, contending that a national thirst for economic equality may have stunted progress. Some even maintain that a democracy may be less able than an authoritarian government to promote growth in a poor country.

Like China, India has a growing middle class — it is just not growing as quickly, perhaps in part because India's expansion started in 1981, 13 years after China's.

The Chinese economy has been expanding by 8 to 10 percent a year for the last two decades, while India's has been growing at a still healthy 6 percent only for the last decade. India's population is growing twice as fast as China's, moreover, so income growth per person has been slower in India.

Both countries are encumbered by many government-owned enterprises with low productivity — for India, most notably, its monopoly on distribution of electricity.

The Indian economy has a few genuine bright spots. Pockets of high-tech prosperity have popped up in two southern cities, Bangalore and Hyderabad.

These have benefited from India's willingness to allow free trade and minimal regulation for new industries, often involving computer software, telephone service centers for financial institutions and other service industries that do not involve moving goods on India's poor roads.

But success stories like Bangalore and Hyderabad remain a tiny part of the overall economy, because software companies hire workers by the hundreds and not by the tens of thousands, as manufacturers do.

"You look around and the rest is a disaster," said Joydeep Mukherji, an Asia analyst with Standard & Poor's.

"One billion people are not going to be programming computers; they're going to be making shoes and cars, and serving coffee."

Indian shoe companies had as much cheap labor available two decades ago as Chinese companies, and workers here were better educated. Yet Chinese manufacturers increasingly dominate the global shoe market. "In the shoe industry, China has gotten ahead and will stay ahead," said Martin Merz, a partner in NJB Merz Ltd., a shoe company in Hong Kong.

Mr. Gupta and his family control the Action Group, India's second-largest shoemaker, after Bata. But the newest of Action's dozen factories, next to a dirt road across the city line in New Delhi, is unlikely to inspire fear in foreign competitors. The cramped building has room for just 150 workers, not enough to achieve the economies of scale of Chinese factories, where up to 20,000 toll in a single complex.

Mr. Gupta said local regulations prevented him from building anything bigger. Particularly onerous are laws limiting how much land a company can acquire in a city. The laws are intended to discourage speculation and leave land available for housing, but they make land expensive for new business ventures.
To walk inside the dimly lit factory on a recent morning was to enter a pungent cloud of glue vapor rising from the open pots and brushes that the workers use in assembling shoes. A. K. Sharma, the factory manager, explained that the factory’s ventilation had been switched off because of an electricity blackout.

The factory had been running for the last three days on diesel generators, at more than twice the cost of using electricity from the municipal grid; another factory here in Sonipat runs an hour or two on generators every day because of blackouts.

Power failures are rare in the Chinese province of Guangdong, where domestic and foreign companies have invested heavily in power plants, but they are a regular occurrence here. Yet Mr. Gupta had to build his latest factory in the city because electricity was not available at all in many rural areas.

Stacked in the basement are rows of large boxes, each holding dozens of pairs of shoes. Scribbled in purple pen on the sides are the size, style and color of each box’s contents. There are no computer-printed labels, and shoe stores in India do not expect them, Mr. Sharma explained.

The boxes, next to many sacks of raw materials, signal another problem. The factory keeps a two-month supply of raw materials and a one-month supply of finished shoes, a huge inventory tying up money that could otherwise be invested in modern machinery. By contrast, Chinese factories keep small inventories, because they receive regular deliveries of raw materials from nearby suppliers and ship finished goods easily on smooth highways to efficient ports like Hong Kong’s.

The minimum wage for urban industrial work here is $3 a day. While fairly high by the standards of very poor countries, it is lower than the wages in Guangdong, where competition for skilled shoemakers has pushed up pay.

Some changes are starting to appear here. Construction has begun on new freeways. A quarter of India’s states have repealed laws limiting business ownership of land in cities. The central government is mulling whether to allow private distribution of electricity, a step that could bring the investment needed to make blackouts less common.

India is starting to lower its 35 percent tariffs on a wide range of goods, including shoes, forcing producers to compete internationally. Mr. Gupta said he was unconcerned, because tariffs will also fall for imported shoemaking machinery and because he believes that Indian workers make higher-quality shoes.

Indeed, the Gupta family’s latest project has little to do with shoes, reflecting instead the human values and limited interest in the global market that still characterize many Indian businesses.

Comfortable with its share of the domestic market and not eager to increase the 3 percent of production that it exports, the family is donating $9 million for the construction of a five-building, state-of-the-art, nonprofit hospital to care for the poor.

While an American family might seek as large a business empire as possible, Mr. Gupta said, his family is more interested in public service. “What would we have done with that empire?” he asked. “It’s a matter of thinking.”
Poverty in India

Trees versus people

BADAMA

Some of India's poorest are the victims of a scheme to plant more trees

To people in the impoverished hamlet of Badama, in the south-eastern part of Uttar Pradesh, India's most populous state, January 1st is independence day. On that day in 2000 they seized rights to mine stone on nearby land, ridding themselves of exploitative contractors. Their wages nearly tripled from a pittance of 20-25 Indian rupees (about 50 American cents) a day; their children started going to school. In celebration, the villagers built a temple, the only structure in Badama that rises much above brow level.

Now their newly won freedom is in peril, this time from the Forest Department, which recently came into possession of the land mined by Badama and three other villages. The acreage is not exactly sylvan: a few mango trees punctuate a landscape of rock and dust. But it is now officially forest and, unless the central authorities in distant Delhi say otherwise, may be used only for forestry, however unofficially barren it may be. And so some 500 people stand to lose livelihoods that only recently lifted them above subsistence. "We'll starve," predicts Moolchand, a wizened veteran of the quarries.

The fate of Moolchand and his fellow stone-breakers will be decided somewhere along a chain of authority that starts with the district forest officer and reaches up to India's Supreme Court. Their plight is unique only in its details. For millions of Indians, survival depends on the verdict of a mysterious machine, its inwards a mesh of ancient notions of caste and modernising zeal, local conditions and distant decisions, good and bad intentions and their unintended consequences, institutional successes and failures.

Badama and nearby villages are peopled by Kols, tribal folk who migrated a few generations ago from Madhya Pradesh, a neighbouring state, to escape bondage to feudal lords. Landless and destitute, they settled on the lands of the raja of Shankarpur and took up a strenuous but simple trade: smashing rock into gravel. Stone-breaking has its virtues. It requires neither schooling nor capital; Amar Saran, a lawyer based in Allahabad, the district's main town, calls gravel a "cash crop," which can be harvested year round. Yet the Kols found themselves ensnared in a new sort of servitude, woven by contractors with mining leases obtained from the raja (who still claims mining rights to 46 villages). They were paid less than half the legal minimum wage (about 60 rupees in Uttar Pradesh today); sickness or marriage brought debt; some families allegedly repaid with the bodies of their wives and daughters.

In the late 1990s an NGO called Sankalp began helping the stone-breakers to organise small "self-help groups". A dozen or so obtained leases to mine state-owned land, eliminating contractors. On the domain of the raja, who seemed reluctant to deal directly with the stone-breakers, they more or less seized the land with quiet consent from the local authorities. It was a rare victory for the downtrodden. It has not made the stone-breakers rich, just slightly less wretchedly poor. Badama has no electricity; its hand pump is broken and the well yields mud. Its 35 huts harbour 12 cases of tuberculosis, the villagers say. But their nemesis is the Forest Department, which has begun building a wall around the property and posted sentries.

There are green reasons for the Kols' impending dispossession. It is a national policy to raise forest cover to a third of Indian territory from a fifth now. State governments, which own most forests, must seek central-government approval for any shift in the use of forest land. The Supreme Court in Delhi, which so mistrusts the state that it has become a maker and enforcer of law as well as its ultimate interpreter, now monitors such transfers. So when the state turned over 187 hectares (460 acres) of forest for a planned refinery near Badama, a plot the same size had to be found for the Forest Department.

Why that particular plot? Biswajit Banerjee, the divisional forest officer, admits that the rocky soil is of little use for planting trees. A "privileged class close to politicians" has cornered much of the better land, he says. The Kols have no such clout.

Mr Banerjee is the first arbiter of their fate and it is not clear how he will rule. His demeanour and record bespeak conscientiousness. He was transferred to Allahabad, reportedly, after clashing with an MP over illegal plundering of forests in another part of the state, a common fate for officers who defy power. He concedes that, technically, breaking stones might help replenish ground water. Mr Banerjee boasts of bringing a "human touch" to his work. Yet he seems to prefer trees to people, or at least to the Kols. India's burgeoning population is crowding out forest, he suggests, arguing that "people of quality should come up, not just inferior grade".

Mr Saran, the stone-breakers' advocate, tries to soften him up. Give the Kols the means to feed themselves and they will protect the trees, he urges. Refuse, and they may become violent, left-wing "naxalites" as others have in states such as Bihar.

Mr Banerjee is considering: Mr Saran is rehearsing arguments for the courts, whose green zeal has inadvertently endangered the stone-breakers of Badama; and they are praying that forces they dimly comprehend do not break them.
India Privatization Is Back on Track

By Joanna Slater

Bombay, India—After months of political infighting, India took a major step toward reviving its privatization program with the announcement of a strategy to sell stakes in two state-owned oil firms.

In a speech to parliament in New Delhi, the minister in charge of privatization told lawmakers that the government had agreed to sell a stake in Hindustan Petroleum Corp. to a strategic investor. It also will sell a portion of its holding in another major state-owned oil company, Bharat Petroleum Corp., to the public through a share offering.

The plan represents a compromise reached after three months of feuding behind the scenes that had dismayed foreign investors and economists. Originally, the government intended to sell stakes in both oil companies to strategic partners, but modified its plan in the face of internal opposition.

The controversy revealed deep schisms within the ruling coalition over the speed and structure of India’s privatization program, one of the current government’s major accomplishments.

Until this fall, the energetic privatization minister, Arun Shourie, had unusual success in auctioning off pieces of India’s vast and troubled public sector. But that momentum came to a halt in September, when the government’s own ministers objected to the sale of the two oil companies and forced the Prime Minister Atal Bihari Vajpayee to postpone a decision on whether to proceed.

The main question is whether other government-owned energy companies such as OIl & Natural Gas Corp. will be allowed to bid for Hindustan Petroleum. If so, outside investor interest may be muted due to fears that the bidding could be slanted in their favor. If public firms are barred from the bidding, the sale of Hindustan Petroleum is “certain to generate very significant interest” from foreign and domestic investors alike, said one investment banker.

Another issue that wasn’t addressed in the statement to parliament was the time frame for the sale of Hindustan Petroleum or the listing of Bharat Petroleum. The government holds a 51% stake in the former and a 66% stake in the latter. Mr. Shourie didn’t disclose what proportion of its holdings the government plans to sell, but in other privatization deals, it has aimed to reduce its ownership to 26%.

For Mr. Shourie, yesterday’s announcement represents a partial but critical victory that also will revitalize other privatization deals now under way, such as the sale of National Aluminium Co., India’s largest aluminum producer.

With the support of the prime minister, Mr. Shourie overcame the objections of powerful political figures like Defense Minister George Fernandes and Petroleum Minister Ram Naik. Both opposed the sales on concerns about national security and the creation of a potential monopoly.

Satellite Photos Appear to Show A North Korean Labor Camp

By John Larkin

Seoul, South Korea—Satellite images published last week appear to refute North Korean denials that it runs slave-labor camps, further tarnishing the reputation of a Stalinist regime that recently admitted to kidnapping Japanese nationals and to developing nuclear arms in violation of an international agreement.

The images were purchased from DigitalGlobe, a Longmont, Colo.-based commercial provider of satellite imagery, after the Hong Kong-based Far Eastern Economic Review handed over geographic coordinates for camp No. 22, nestled in the mountains of North Korea’s

Brazil’s da Silva, Bush To Meet to Firm Ties

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Bush’s debt and new threat: surging inflation.

The resignation of U.S. Treasury Secretary Paul O’Neill, whose flippancy comments had made Brazilian markets swoon, removes one irritant in relations. But the meeting occurs at an awkward moment: Mr. da Silva hasn’t unveiled his economic team. He will be accompanied by his likely finance minister, Antonio Palocci, who has toned down the Workers Party’s nationalist rhetoric and impressed foreign investors with his pledge of budget prudence.

Smoothing prickly commercial ties remains a tougher challenge. Mr. da Silva has vowed to drive a harder bargain than his predecessor on breaking down U.S. protectionism—mostly in farm goods—to achieve the proposed 34-country Free Trade Area of the Americas accord. Some da Silva aides don’t think the 2005 deadline is feasible; others prefer a bilateral trade deal. But contrary to campaign rhetoric in which Mr. da Silva said the FTAA is tantamount to U.S. “annexation,” he has since made clear that he will engage in trade talks-as part of a South American bloc—not out of. He is to meet U.S. Trade Representative Robert Zoellick today.

Oil Sl

Continu
Electricity in China

Power politics

June 8, 2002

Are China's electricity reforms doomed to fail?

In April, after a decade of political wrangling, China's government announced a blueprint for reforming its power sector. The plan's chief drawback is not that it said anything wrong, but that it said so little. "All eyes are now on the details," says Scott Roberts, an analyst in Beijing for CEEA, an American energy consultancy. And these are now being decided behind closed doors in various committees of the Communist Party, just as it prepares to change its leadership at a party congress later this year. The real political wrangling, in other words, has just begun.

Broadly, China, like many other countries that are reforming their electricity industries, is looking to Britain's deregulation in the 1980s as a model. Thus, China plans to split power generation from transmission, and to let four or five generators compete to supply the grid (which will itself be split along geographic lines). According to David Victor, director of energy research at Stanford University, the key variable that determines whether such a model works in the countries that he has studied is the institutional framework. Is the regulator genuinely independent? Is there rule of law and sanctity of contract? Are electricity companies properly and transparently governed? And so forth. Hence the worry that, if even California struggles to meet such conditions, China stands barely any chance of doing so.

Under China's brand of "socialism with Chinese characteristics", the state dominates all big industries. But the power sector is easily the most politicised. After a decade of hesitant and arbitrary reforms, it is also among the most corrupt and inefficient. On top of the industry sits the State Power Corporation (SPC), China's largest state-owned company. It controls the grid, as well as about half of China's generating capacity. The other half is shared by a number of independent power producers, or IPPs. These tend to be independent in name only, since the SPC wields influence through ownership stakes or personnel links, even in the three IPPs that are listed on the Hong Kong stock exchange.

Crucially, the electricity industry is the traditional power base of Li Peng, a hardliner who used to be electricity minister and is now chairman of the National People's Congress. Mr Li is one of the top Communist leaders due to retire during the coming year, and is thus keen to keep the industry under his patronage. His son, Li Xiaopeng, not only heads Huaneng Power, the largest IPP, but is also a director of the SPC. His daughter is an executive at another power company. The Li family has been pitted against the market reformers in the party—including Zhu Rongji, China's prime minister, who is also due to step down. The LIs have not been able to block change, but they appear to have succeeded in watering down a more radical reform plan proposed last year.

For now, the result of all this politicking is a mess. Local and provincial officials have for years been building new plants for prestige (and with dubious licences), leaving large parts of China with a massive power glut. Nonetheless—and despite cost advantages in labour and fuel—Chinese consumers pay about 30% more for their electricity than do Americans.

In this environment, politically favoured companies do well, but those without connections suffer. The worst hit include a few hapless foreign investors, whom Beijing had invited to build plants in the early 1990s, when China faced an electricity shortage. Now, in the glut, provincial governments are reneging on their contracts with foreigners and refusing to pay. The finance director of the Chinese
GREATER CHINA

The mainland is absorbing the economies of Hong Kong and Taiwan faster than you think. How will this new superpower affect the world?
A decade ago, local farmers were baffled why the city of Shanghai had decided to extend the No. 2 subway line across the Huangpu River all the way to their township of Zhangjiang, at the time just a marshy expanse of rice fields and fish-filled canals. Many electronics experts, meanwhile, regarded official predictions that this site would become a high-tech park brimming with state-of-the-art semiconductor plants as laughable. The most likely investors, Taiwan’s big chip manufacturers, were forbidden by their government from transferring such sophisticated facilities and technology to the mainland.

Yet with stunning speed, this vision is becoming reality. Last year, Semiconductor Manufacturing International Corp. (SMIC), headed by former Taiwanese chip executives, opened a $1.5 billion silicon wafer fabrication plant. SMIC is preparing to build another one. Right next door, a joint venture headed by Taiwanese electronics tycoon Winston Wong has opened another sophisticated wafer fab. Taiwan Semiconductor Manufacturing Co., the world’s leading contract chipmaker, is planning a wafer fab nearby, too. These are among 70 electronics companies that now have facilities in the 9.7-square-mile zone, which also hosts research labs for Sun Microsystems, LG, and Sony. A 400-researcher lab by General Electric on the way. Indeed, predictions that Zhangjiang will someday rival Taiwan’s renowned Hsinchu Science-Based Industrial Park no longer seem outlandish. “We are just at the initial stage,” says Dai Haibo, CEO of the company that manages the zone. As more labs arrive, “we will be like Hsinchu combined with Silicon Valley,” says Dai, who expects Zhangjiang’s workforce to reach 200,000, in a decade.

Zhangjiang is but one focal point of one of the biggest economic mergers in history—as profound as the integration of Europe or North America. The concept of a Greater China has been developing since the 1980s, with the mass influx of manufacturers from Hong Kong, and then Taiwan, to the southern China coast soon after Beijing opened its doors. But in the past year, with China’s entry into the World Trade Organization, the industrial unification of the three economies has hit warp speed and is spreading deep into the mainland. Political barriers to investment in once-strategic industries such as semiconductors, oil, and banking are crumbling, infrastructure systems are fusing—and Hong Kong and Chinese officials are collaborating on regulatory affairs.

Clearly, Hu Jintao, who was just named General Secretary of China’s Communist Party at Beijing’s 16th Party Congress, inherits the stewardship of an economy that is vastly different from when Jiang Zemin took full control in 1997, as China was just beginning to seriously whittle down the state sector. This is also an economy that is developing with less and less guidance from the center, and that often makes the tension-filled politics of Taiwan-China relations seem like a sideshow. Beijing is starting to realize that its goal of absorbing Taiwan is best served by letting the process proceed—not by hurling threats against Taipei. “The general policy now is to be confident and patient,” says Wang Yong, executive director of Beijing University’s Center for International Political Economy Research. “We should let the forces of integration play a larger role in determining the shape of cross-Strait relations.”

A few manifestations of this accelerated convergence:
- In the past two years, the number of Taiwanese officially living on the mainland has swelled from 300,000 to 500,000. And some estimates run much higher. Several thousand Taiwanese students are pursuing degrees in China rather than at U.S. universities.
- This year, China will pass the U.S. as Taiwan’s biggest export market. Within the next year or two, when approval for direct shipping and air links are approved, cross-Strait trade will surge even more.
- China has passed Taiwan as the world’s No. 3 maker of...
information-technology products. But many of the benefits flow to Taiwan companies, who control 70% of the output. China has overtaken Taiwan as a maker of desktop PCs, optical drives, and liquid crystal displays. The share of Taiwanese notebook PCs made in China has leaped from 4% to 30% since early 2001.

- In a bid to maintain the Pearl River Delta’s competitive edge over other parts of China, business and government leaders in Hong Kong and Guangdong are discussing a $1.9 billion bridge linking Hong Kong to Zhuhai and Macao, rail and subway links, easier border crossings at Shenzhen, and ways to coordinate the services of the Delta’s five airports.

- Hong Kong’s role as an international financial window for China is growing. Quicker regulatory approval prompted Bank of China (Hong Kong) to float its initial stock offering in Hong Kong rather than New York, while dozens of other Chinese companies have listed on Hong Kong’s new second board aimed at startups.

The impact of Greater China as an exporter is being felt worldwide. Its share of total exports has gone from 6.9% to 9.8% in just four years, surpassing Japan, according to the World Bank. By 2007, it should reach 13.9%. Also by that time, as the mainland and Taiwan open their markets to comply with WTO commitments, Greater China should pass $2 trillion in exports and imports, excluding the trade between the three economies, estimates Goldman Sachs & Co. (Asia). That would make it nearly twice as big as Japan as a trading power and two-thirds the size of the U.S. Measured in terms of purchasing power, the World Bank estimates Greater China will overtake the European Union in five years, with a combined gross domestic product of $1.2 trillion. By that yardstick, it would be nearly triple the size of Japan. The market capitalization of the bourses of Hong Kong, China, and Taiwan could challenge Tokyo’s $2.1 trillion by then.

You can expand this concept of Greater China even further if you include the huge populations of overseas Chinese who still consider the mainland home and increasingly are returning to start businesses there. Of the more than 400,000 Chinese who have studied overseas in the past two decades, some 140,000 have moved back, bringing with them advanced degrees, Silicon Valley experience, and venture capital. Shenzhen Mayor Yu Youjun reports that his city already has 300 companies run by returnees. More than 1,000 overseas-educated Chinese move there each year.

Stretched a bit more, and you have China as the hub of North Asia. Ex-McKinsey & Co. consultant Kenichi Ohmae argues that what’s emerging is a United States of China, with dozens of growth zones essentially renting themselves out to foreign investors. He estimates 100,000 South Koreans live in cities such as Qingdao and Tianjin; some 4,000 Japanese companies have operations near Dalian. Singaporean companies also are a big source of capital.

The real architects of this growing economic colossus are the entrepreneurs of greater China and the officadom of cities such as Shanghai, Chongqing, Shenzhen, Dongguan, and Hong Kong. They have spent two decades creating networks of influence and putting down roots, advantages that will be extremely difficult for other foreigners to match. Equally important, these players are providing China with the managerial and financial expertise needed to compete in the world.

Why is this process speeding up? The biggest driver is China’s economic reforms, now anchored by its entry into the WTO. Another is the ever-deepening integration of Hong Kong since the departure of the British in 1997. Security regulators and monetary authorities from Hong Kong and Beijing now work closely with each other. Meanwhile, mainland companies such as Bank of China, which used to be shadowy presences in Hong Kong, now use it as a base to learn international management standards. InvestHK, a Hong Kong government body, has set up three teams dedicated to bringing mainland companies to the territory.
After years of trying to keep its distance, deflation-ravaged Hong Kong is also looking to the mainland as a savior. A few years back, Hong Kongers were willing to commute by hydrofoil or bus to factories in the Pearl River Delta, but few wanted to live on the mainland.

Now, they're fighting for jobs there. Thousands flocked to a mainland job fair in Hong Kong early this year. Hong Kong property magnate Vincent Lo says he has to turn down transfer requests from all but his most highly skilled Hong Kong staff.

Calmer relations across the Taiwan Strait are also helping. Just 18 months ago, when longtime opposition candidate Chen Shui-bian took office as President, Beijing lashed out at every defiant move by Taipei. Lately, China has downplayed Chen's remarks on Cross-Strait issues. It has also signalled it may be willing to consult Taiwan on trade issues, and has toned down demands that Taiwan accept its "One China" principle before having such contacts.

Both sides clearly would benefit from full-fledged cooperation. Taiwan still bans imports from China of thousands of products, from car engines to most farm goods. Worse, the lack of direct transport links, which turn a one-hour flight into a day-long ordeal, puts an additional $60 to freight costs. Removing all such barriers would add 3% to the economic growth of both Taiwan and China by 2011, calculates George Mason University economist Zhi Wang. It also would boost their combined exports by $10 billion a year. "Political relations can slow integration," says Acer Inc. Chairman Stan Shih, who has set up factories across the mainland. "But economic movement just cannot stop."

Talent from Taiwan and Hong Kong has been pivotal to China's ability to maintain annual growth rates of at least 7%. It plays a key behind-the-scenes role at advanced plants and research labs provided by multinationals such as Cisco Systems, Ford Motor, Nokia, Sony, and Motorola. "All of our Chinese plants are being built with Taiwanese managers," says Gerard J. Kleisterlee, CEO of Royal Philips Electronics, which
has cut its Taiwan workforce from 12,000 to 4,000 in the past few years as it shifted production to China.

You get a glimpse of the new China at Shanghai's Xintiandi. Just a few years ago, its rows of tile-roofed shikumen, or stone houses, were crumbling relics of a colorful past. In the mid-19th century, when this 128-acre area was the heart of the French Concession, Chinese from surrounding provinces crowded here to escape the Taiping Rebellion. Decades later, when Shanghai was Asia's top commercial hub, the area boasted clubs and nightspots where young Chinese mingled with Europeans or plotted revolution. After the 1949 Communist victory, the prosperous Chinese in Shanghai scattered abroad.

Now, every night, ethnic Chinese from Taiwan, Hong Kong, and the U.S. mingle with the mainland's nouveaux riches in the painstakingly renovated shikumen, home to the city's hippest restaurants, boutiques, and bars. Renowned painter Chen Yifei owns a stylish clothing shop, and one of Taiwan's biggest food companies owns the local Starbucks's Corp. franchise. Tycoon Vincent Lo, born and bred in capitalist Hong Kong, is heading redevelopment of Xintiandi into a $3.5 billion complex that will include high-end apartments and a 68-story building with a luxury hotel. In a twist of irony, the First Congress Hall, where the Chinese Communist Party convened its first meeting in 1921, sits amidst the hubbub, newly renovated as a tourist attraction.

Xintiandi shows the consumer side of integration. Other economic hotspots offer glimpses of how far industrial integration has come. The steamy Pearl River Delta is rich with such examples. The sprawling campus of Taiwan's Wistron Corp. in Zhongshan, an electronics contract manufacturer spun off from Acer, looks as if it was transplanted from Hsinchu, Taiwan's technology heartland. The neatly manicured grounds include dormitories with basketball courts for its 2,800 workers, a 200-engineer software-development lab, and three factories making desktop PCs, set-top boxes, DVD players, and PDAs—almost all for export. Soon, the Zhongshan facility will make Xbox game consoles for Microsoft Corp.

A chief lure of the region is the mass transfer of Taiwan's components industry. "Guangdong Province has the most developed component-supply base in the world," says Jeff Tsao, general manager of the Wistron plant. Only two years ago, at least 80% of the components used in Taiwan-owned factories in South China came from Taiwan. Today, more than half are sourced locally, and the share is growing fast, estimates Beijing-based economist Andy Rothman of CSA Emerging Markets. Even executives who visit the region frequently are stunned at the pace of change. During a recent visit to his company's factory in Shenzhen, James E. Sacherman, chief marketing officer for contract-manufacturing giant Flextronics International Ltd., says he asked his staff there if he could buy certain cables locally. He was told there were now 300 suppliers in the immediate area. "It's all

TAIWAN'S SILICON INVASION

In 1999, Richard Chang could have easily retired. He had just sold his fledgling Taiwan chip company to industry giant Taiwan Semiconductor Manufacturing Co. for $2.5 billion. But Chang, who spent 20 years at Texas Instruments before starting his own business, wasn't ready to slow down. He saw a wealth of opportunity in the growing integration of the economies of Greater China. Now tapping Taiwan expertise and drawing from the pool of skilled workers on the mainland, Chang wants to help China build a world-class chip industry. "We like to be Taiwanese and mainlanders work together," says Chang, 51. "We can complement each other.

Chang is betting that his team will earn quickly. His Shanghai-based Semiconductor Manufacturing International Corp. (SMIC) opened its first chipmaking plant last year, and it is launching a second in December—with plans to build a third in Beijing, in a few years. All told, Chang has raised more than $1.5 billion from a roster of investors that includes Goldman Sachs, HSBC Asia Pacific, and Toshiba. Although the company is still a fraction of Taiwan Semiconductor's size, says it is the most advanced chipmaker in China today and has won big customers such as Fujitsu, and partnerships with Toshiba and Chartered Semiconductor.

SMIC's launch has spooked many Taiwanese, who fear they are losing their edge in a vital industry. Yet Chang, who was born in Nanjing but moved to Taiwan with his parents as an infant during the Chinese civil
A DEVELOPER DRIVES INTO THE HEARTLAND

Back in the mid-1980s, many of Hong Kong’s moneyed elite were cashing in their chips and moving abroad in fear that a Chinese takeover would destroy the British colony. But Vincent Lo didn’t budge. Indeed, he decided the time was ripe to bet on the mainland. The son of a prominent Hong Kong developer, Lo had set up his own development and building-materials company in the early ’70s. Then, in 1985, he launched a $23 million venture with the Communist Youth League to finance a hotel in Shanghai.

That investment is now blossoming into a multibillion-dollar portfolio of commercial and residential projects. Lo, as much as anyone, has set out to reshape urban China by building developments that reflect the country’s unique “PEOPLE THOUGHT I WAS CRAZY”

Lo’s mainland assets may grow to 80% of his holdings

history while embracing modern planning. Today, half of the assets of his Shui On Holdings Ltd. are on the mainland—mostly in Shanghai real estate—and he expects that to grow within two years to 80%. “A lot of people thought I was crazy,” says Lo. His answer: China “will propel the whole world’s growth.”

Lo’s crown jewel is the glitzy Xintiandi project in Shanghai. The two-year-old development mixes commercial space with dozens of restaurants and boutiques in a historic neighborhood. The final price tag by the end of the decade: $3.5 billion. Xintiandi has been such a success that Lo is now backing a similar project in Hangzhou, 100 miles south of Shanghai.

Now, Lo is in the vanguard of the next big move for Hong Kong money: the investment drive deep into China’s vast heartland. Four years ago, Lo founded a group to spur economic development in the Yangtze River basin, stretching from Shanghai to Chongqing.

This year alone, the indefatigable 54-year-old developer has made three trips to the U.S. and Europe to drum up investment for the region. “The opportunities are in the interior,” he says.

Lo is backing that hunch with big money. He and his partners have invested more than $100 million in a string of formerly state-owned cement plants in Chongqing, Guizhou, and Sichuan in a bid to profit from rapid growth in China’s west. Local officials welcome the tax revenues, the jobs, and a new way of looking at things.

Through his investment, Lo “solved financial problems and installed a modern management system” at the Di Wei cement factory, says Guo Ruqi, the Communist Party secretary in Jianglin, Chongqing county with 1.5 million residents 25 miles south of the city center. Part visionary, part cement salesman, it’s an unusual combination. But Lo is doing his bit to modernize China.

By Mark L. Clifford in Chongqing
sues FedEx plans to open offices in 100 new Chinese cities over the next five years. Besides developing Shanghai's Xintiandi district, for example, Vincent Lo has bought up cement plants in Chongqing and the provinces of Sichuan and Guizhou. In October, Lo led a delegation of more than two dozen businesspeople to look for opportunities in Chongqing.

Perhaps Hong Kong's most crucial role, though, is as Greater China's Wall Street. The Bank of China is making its Hong Kong affiliate a laboratory for good banking practices in one of Asia's most sophisticated and well-regulated capital markets. The Industrial & Commercial Bank of China has set up a merchant-banking arm in the city.

China also is tapping Hong Kong government talent. Former top Hong Kong Securities & Futures Commission (scrc) official Laura M. Cha has taken a staff job in Beijing at the China Securities Regulatory Commission (csrc). She is helping draft reforms that, among other things, will permit foreign investment in China's publicly traded state enterprises. Former Hong Kong scrc head Anthony Neo is the csrc's senior adviser and helped push through new proposals to allow foreign portfolio managers to buy Chinese stocks. "China needs Hong Kong because it can't manage its own pool of domestic savings" of some $500 billion, says Brookings Institution economist Nicholas Lardy. "This help in building China's financial infrastructure is hugely important."

Financial industries also are melding as Beijing gradually opens its banking sector to foreigners. Last December, Hong Kong & Shanghai Bank bought a stake in Bank of Shanghai. And mainland-born Wei Jian Shan, who heads U.S.-based Newbridge Capital's office in Hong Kong, is leading negotiations to buy a stake in Shenzhen Development Bank Ltd. If the deal closes, Newbridge would be the first foreign institution to control a mainland bank.

In yet another sign of how integration is breaking down barriers, the banks of Taiwan and China are starting to comingle. In the past year, Beijing has allowed several Taiwan banks to open offices, while China's Shanghai Pudong Development Bank and Fujian Industrial Bank have applied to do business in Taiwan. Even major government-owned companies are starting to cooperate in ways unimaginable just a year ago. Taiwan's China Petroleum Corp. is jointly exploring for reserves with Beijing's China National Offshore Oil Corp., and Taiwan's China Airlines has just won approval to buy a stake in the mainland's China Cargo in anticipation of new business with the establishment of direct flights.

There are potential hazards to full-fledged economic integration. As Taiwanese and Hong Kong companies become

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**YU YOUJUN**

**A MODERN MAYOR**

Yu Youjun heads China's most open city, a haven for Hong Kong and Taiwan electronics makers. He's in charge of a rapid reform program that serves as a model for the entire mainland. And even though he has a PhD in Marxist studies—and served as the Communist Party's propaganda chief for Guangdong Province—Yu studied business at Zhongshan University and has long backed China's opening to the world.

This résumé helps explain why Shenzhen Mayor Yu has become a pivotal player in China's integration with Taiwan and Hong Kong. Energetic and open-minded, 39-year-old Yu is one of a growing breed of Communist Party cadres guiding China's transformation into a modern market economy. After taking the helm in Shenzhen in 2000, Yu quickly began pushing to open state-dominated sectors to foreign investment. For instance, he's backing Newbridge Capital's proposed acquisition of Shenzhen Development Bank Co. And he encourages overseas investors to buy stakes in enterprises that provide gas, water, and food in Shenzhen. "We are a pilot city for carrying out reforms," Yu explains.

Yu also has played a key role in wooing Taiwanese investment. Last year, he traveled to Taipei on a promotion tour—the first trip across the Taiwan Strait by a mainland mayor since 1949. Some 3,400 Taiwanese companies already have invested $4.7 billion in Shenzhen factories, making everything from computer monitors and cell phones to cables and keyboards. Now, Taiwanese companies are tapping China's vast pool of cheap and able engineers.

Yu's long-term agenda is ambitious. He wants to move more thoroughly link Shenzhen to Hong Kong by improving the city's four border crossings, developing joint research centers with tech institutions in the city, and meeting regularly with regional officials. As Yu sees it, Hong Kong will continue to lead the mainland in financial and information services, while Shenzhen will be the production and engineering base for light-industrial goods, software, and advanced electronics.

High-gear capitalism may seem like an odd agenda for a former propaganda chief. But during Yu's years in the Guangdong government, the province was regarded as the most progressive in China. Now, he sees himself serving his country by building a stronger Shenzhen and tying it to Hong Kong and beyond. "If we combine our strengths, we can become a high-tech and service base for all of Asia-Pacific," says Yu. Think of that as propaganda for the new China.

*By Dextor Roberts in Shenzhen*
more dependent on China for their manufacturing, components, engineering, and markets, they will become more vulnerable to a political or financial crisis there. Both remain distinct possibilities: China's banking system is in precarious shape, with an estimated $700 billion in bad loans. Millions of angry workers with scant pensions are losing their jobs at state-owned industries, and labor protests are breaking out. "In a crisis, Chinese labor could become as destabilizing a force for the world economy as oil prices," says Ted Dean, managing director at information-technology consultant BDA (China) Ltd. in Beijing.

There also is the possibility that political tensions could once again sour Taiwan-China relations. It was only two years ago, after all, that China implied it was ready for war if Taipei didn't start seriously negotiating to rejoin the mainland. Taiwanese political leaders could provoke Beijing again by taking steps toward independence. As for Hong Kong, the worry is that ineffective leadership will squander many of its advantages—a strong rule of law, good civil service, free media, and tough anti-corruption stance—and blur the distinction with the mainland.

Still, there is a more encouraging way to view the Chinese convergence. As more and more citizens of Taiwan, Hong Kong, and China live, work, and study together, they increasingly will see themselves as part of one entity. This attitude clearly is disporportional among the Taiwanese students who choose to study at Chinese universities. Taiwan-born Wang Jikang, 28, who is pursuing a master's degree in law at Shanghai's Fudan University, says he decided against a U.S. school because opportunities are brighter in China. Most of his Taiwanese classmates feel the same, he says. "Taiwan doesn't have an economic future outside the mainland," he adds. But because of Taiwan and Hong Kong, the mainland has a much brighter future as well, one that will be shaped increasingly by the best and brightest of all three regions.

By Dexter Roberts in Shanghai and Mark L. Clifford in Hong Kong, with Bruce Einhorn in Taipei and Pete Engardio in New York

A FORCE FOR FINANCIAL REFORM

Few Chinese know how far the country has come in the past 35 years better than Liu Mingkang. For much of the Cultural Revolution from 1966 to 1976, Liu was persecuted because he was the son of a law professor, and he was forced to toil as a peasant in rural Jiangsu Province. He taught himself English at night with the help of a decrepit textbook he had pieced together. After a brief stint as a steelworker, Liu landed a job at Bank of China in 1979, when Deng Xiaoping ushered in his reform. He quickly rose in the ranks and even made time to earn an MBA at City University of London.

These days, as chairman of Bank of China, Liu is perhaps the most forceful advocate of the modernization of China's financial industry—and of its integration with capital markets in Hong Kong and beyond. Liu took the helm of China's second-biggest bank in 1999, and he has steered it through rough waters in the wake of a corruption scandal that embroiled a predecessor. He persuaded Premier Zhu Rongji to let him list shares of its 344-branch Hong Kong operation—which accounts for most of the bank's profits—on the Hong Kong Stock Exchange. Before he could do the initial public offering, Liu oversaw a tricky merger of 13 different banks and financial institutions that were under the bank's umbrella—a delicate exercise that involved intense negotiations with Hong Kong regulators. Liu figured the July, 2002, IPO would force the bank, long known for its secrecy and boosted by renminbi, to become more transparent and to adopt international management standards. Before the listing, "we did not have responsibility or accountability," says Liu, 56. "It's a story of good governance."

Bank of China's example, Liu hopes, will inspire other banks to improve. Already, the Hong Kong affiliate has become a place where bright young financial talents from China are learning modern risk-management techniques that can be transferred to the mainland. A separate investment banking operation, Bank of China International, recently joined a Morgan Stanley-backed venture as the only foreign institution licensed to underwrite international stocks and bonds in China. Because it must now answer to foreign capital markets, Liu also hopes Bank of China will be better able to resist government pressure to lend to politically favored companies.

Liu maintains that standards are improving. "China is changing very fast," he says. It will be up to determined executives such as Liu, equally at ease in the inner circles of Beijing and Hong Kong office suites, to build the sophisticated financial sector that Greater China needs.

By Mark L. Clifford in Hong Kong
A SEISMIC SHIFT TOWARD CHINA

Look East. While America is preoccupied with the Middle East, directing an occasional nod to an expanding NATO and Europe, an economic supernova is rising in Asia—Greater China. The integration of Taiwan and Hong Kong into the fast-growing Chinese economy is creating a boom that is attracting huge amounts of technology, capital, and skilled immigrant labor from all over the world. We are witnessing a macro-event of immense geopolitical and historic significance (page 50). It’s time to ponder the rise of Greater China and the shifting fulcrum of international wealth and power.

Japan is being eclipsed. Europe is being challenged, and the U.S. is torn between benefiting from the Chinese economic dynamo and worrying about China’s Big Power aspirations. The good news for America is that the most contentious issue between Beijing and Washington, the future of Taiwan, is quietly being determined not by invading fleets but by invading businessmen. Much of Taiwan’s high-tech industry is moving en masse to China—and with it, some 400,000 Taiwanese. Taiwanese students are choosing to study in Chinese, not U.S., universities because they see more opportunity there. If China’s political rulers can maintain their patience, the eventual political integration of Taiwan into China is almost a certainty.

What is not so certain is China’s political direction. Greater China’s share of total world exports already exceeds Japan’s, and its economic size will nearly match the European Union’s in five years. But the country is still a dictatorship, ruled by an atavistic Communist Party. How long this can last in a society increasingly open and mobile, both geographically and economically, remains to be seen.

Odds are China will follow two other authoritarian Asian countries, Korea and Taiwan, which developed elective democracies after strong economic growth created middle-class societies. A democratic China would probably be more open to ameliorating tensions with other Asian countries and the U.S. in the future. China has outstanding territorial disputes with four Southeast Asian countries over the Spratly Islands and long-standing border disputes with India and Russia. Its domination of Tibet is of concern to many Americans, and its desire to built a modern military force commensurate with its rising economic power worries the Pentagon.

China already resembles the U.S. in building a dynamic, open economy that generates enormous opportunity and attracts students, immigrants, and investment from around the world. Washington should give China credit for this progress, and allow it time to progress politically as well. And China must recognize that the evolution toward a democratic political system would cement its economic gains—and its rising place in the world, for generations of Chinese to come.
**Peeling Out**

World's Car Makers Race to Keep Up With China Boom

As Sales Surge, Firms Roll Out New Models, Cut Prices; Looming Capacity Glut

A Minivan Called Sunshine

By Karby Leggett

AND TODD ZAUN

SHANGHAI—Foreign auto companies are scrambling to get into the world's fastest-growing major market: China.

After several years of strong growth, China is now the world's fourth-largest auto market, behind the U.S., Japan and Germany. It could leap into second place in three years, even if growth continues to just half its current pace. Private citizens have overtaken the government as China's biggest buyers of automobiles this year. Banks have helped pave the way by offering car loans for the first time, and thousands of miles of new roads have given drivers more places to go.

Auto executives, facing flat or falling sales in their home markets, predict China will be their biggest source of growth over the next decade. Newcomers Toyota Motor Corp., Nissan Motor Co. and Hyundai Motor Co. plan to spend a combined $3 billion in China over the next few years to build or expand factories. Volkswagen AG, General Motors Corp. and Honda Motor Co., all of which entered China years ago, are spending heavily to build the country's first dealer networks and to punch out new models.

So far, the Chinese market has been profitable for most foreign auto companies, thanks to low production costs and relatively high sticker prices. Market leader Volkswagen will generate 15% of its total pretax profit from China this year, according to an estimate by UBS Warburg. Through the end of October, the number of cars, trucks and buses sold in China soared by 36% to 2.7 million, compared with the year-earlier period. Passenger-car sales alone were up 55% and are on track to top one million vehicles this year for the first time.

Now auto makers have begun chopping prices, triggering China's first industrywide price war. They are accelerating the rollout of new models, with some retailing for as low as $5,000. The surge of investment in new plants risks flooding the industry with excess capacity. By 2010, analysts estimate, companies will be able to build 20% more cars in China than they can sell there.

"There are just too many competitors," warns Graeme Maxton, managing director of auto-industry consultancy Autopolis Asia. For some new entrants in China, "it's all going to end in tears."

Auto executives have long predicted that China's car market was poised to explode. But sales for much of the 1990s were disappointing. Now, as prosperity spreads through this nation of 1.3 billion people, the rapid rise in auto sales highlights China's growing muscle in the global economy.

"I'm a big fan of American cars," says David Chao, a 50-year-old owner of a freight-forwarding company in Shanghai. Mr. Chao says the demands of his business and the availability of low-cost
many lives. It will also provide no more than a partial solution to China's problem.

The diverted water would follow three main routes. The western section would involve tunnelling through mountains to link the headwaters of the Yangtze and Yellow rivers. The central route would require building a canal and aqueduct some 1,240km (770 miles) long to the Beijing area. The 1,150km eastern route would mostly follow existing water courses, including that of the ancient Grand Canal.

For the time being, Chinese officials are focusing on the technically less challenging central and eastern routes, which would cost some $20 billion. The eastern route, however, presents a major problem—the water would pass through some of the country's most polluted rivers. Bringing in a supply of polluted water would be of very little use to northern China.

The central route is therefore likely to be the first to get under way and could be completed by 2010. But there are considerable drawbacks to this part of the plan too. The level of the Danjiangkou reservoir would need to be raised by 13 metres (43 feet). More than 200,000 people would have to move. Many would move higher up the surrounding hills, chopping down forest and exacerbating already serious soil erosion. Downriver of the Danjiangkou dam, the water level of the Han River, a major tributary of the Yangtze, would drop, making it more prone to fish-killing algae. Officials say that this problem could be alleviated by pumping water from the Three Gorges reservoir into the Han River.

Some experts in Beijing argue for a different tack. Tackling pollution, using recycled water and forcing people to save water by raising absurdly low prices would go a long way towards alleviating the north’s problems, they say. Once these measures were in place, the diversion plan could be reconsidered. One of China’s best-known critics of the government’s big water projects, Dai Qing, says officials have suppressed debate about the scheme. “They’ll make a lot of money on the side through corruption,” she argues. “It doesn’t matter to them whether it works or not.”

Japan

Harder times for Koizumi

TOkyo

His shrine visit won’t help Japan’s prime minister mollify the right

It was a fudge—and not a very successful one at that. Junichiro Koizumi, Japan’s new prime minister, had pledged before his appointment in April to go to Yasukuni, a controversial shrine for the war dead, on August 15th, the anniversary of Japan’s surrender in the second world war. Last month he started publicly wavering, as protests, both inside and outside Japan, got louder. When he eventually went to Yasukuni, two days earlier than promised and with a minimum of warning, he pleased few and angered many.

Mr Koizumi, the first sitting prime minister to pay an official visit to the shrine in 16 years, had hoped that the change in date and a carefully prepared statement acknowledging Japan’s wartime aggression would mollify critics. He was wrong.

China, South Korea, and other Asian countries were furious that he went to a shrine which honours, among millions of other war dead, 14 “Class A” war criminals, and were not in the slightest bit mollified by his changing of the date. Tensions that had been running high following a row over Japanese history textbooks that omit reference to the sexual exploitation of local women by Japanese occupation forces rose even further: in South Korea a group of particularly incensed men each cut off a little finger in protest. Japan’s foreign ministry, led by Makiko Tanaka, its minister, is now scrambling to patch things up.

Mr Koizumi also lost support at home. Those who opposed his Yasukuni trip—
CAN CHINA TAME THE CORRUPTION BEAST?

Mao Zedong famously warned that a single spark could start a prairie fire. Now China's current crop of leaders are worried that the country's ever more numerous sparks of corruption could ignite an inferno—one that might even see the Communist Party go up in smoke. graft on an unprecedented scale is stretching all the way up from the rice paddies of rural China to high levels of government.

From shakedowns of peasants to massive smuggling campaigns that rob the state treasury of much-needed cash, the scale of graft has reached a level where it may threaten the country's continued economic progress. Indeed, after seeing a top-drawing anticorruption film, Live or Die, in August, President Jiang Zemin described the movie as a "powerful shock and a profound warning."

CAPITAL CRIMES. Certainly, the hunt against corruption is increasing in intensity. In late November, Justice Minister Gao Changli disappeared from his job—detained for questioning on corruption charges, Beijing sources say. In mid-September, a former deputy head of the National People's Congress, Cheng Kejie, became the most senior official to be executed since the People's Republic was set up in 1949.

During the first eight months of this year, Chinese prosecutors filed more than 23,000 criminal corruption cases. Reported corruption cases have increased 9% annually and the number of officials under investigation has been shooting up at an average of 12% per year, says Pei Minxin, a scholar at the Carnegie Endowment for International Peace in Washington, D.C. In the biggest case in Chinese history, 14 officials and smugglers were sentenced to death in mid-November for smuggling $6.4 billion in goods into China through the coastal province of Fujian. And authorities recently released the results of an investigation into officials in booming Guangdong:

The report estimated that corrupt officials purloined $1.9 billion in funds, largely from provincial businesses.

The stepped-up anticorruption efforts reflect fears among leaders that widespread criminality could destroy what's left of the party's legitimacy as the country enters a difficult phase of its economic reforms. China's entry into the World Trade Organization means that millions more workers will lose their jobs as factories are restructured or shuttered. The problem is that corrupt officials are living it up while workers struggle. It's hard to tell steelworkers in Shenyang, to take a recent example, that they're being laid off when a top municipal official lost $1.3 million in stolen funds at a Macau casino.

EROSION. "People in China can tolerate short-term pain provided there is a sense of justice, that the pains are equally shared," says the Carnegie Endowment's Pei. He thinks that a stronger legal system, a freer press, and more grassroots democracy are needed to check corruption. Inevitably, though, those changes would force the Communist Party to surrender its monopoly on power.

Corruption now costs China the equivalent of 8% of GDP annually in lost taxes and tariffs, figures Hu Angang, a senior fellow at the Chinese Academy of Sciences. And it looks set to worsen. China's courts are too weak to fight corruption effectively. Its fitsful experiments with local democracy are too small to do the job. Luckily for China's leaders, the sparks of graft in the countryside haven't yet grown into a nationwide fire: That would take a unifying national issue rather than a collection of local grievances. But, there's plenty of kindling in a country tired of being ripped off by its own officials. China's leaders are—and should be—worried.

By Mark L. Clifford in Hong Kong, with Dexter Roberts in Beijing

GLOBAL WRAPUP

ENDGAME FOR MILOSEVIC?

► Despite his hopes for a comeback, the political destruction of former Yugoslav President Slobodan Milosevic is nearly complete. His menacing regime fell to pieces after he tried to steal Yugoslavia's Presidential election in September. Now his Socialist Party of Serbia (Sps) is crumbling, too.

Polls show the sps may garner only 2% to 3% of the vote in Dec. 23 elections for the regional Serb parliament—below the 5% threshold needed to claim seats in the legislature. More than 60% of the electorate is expected to vote for the Democratic Opposition of Serbia, the coalition that ousted Milosevic by organizing protests and strikes.

Such a strong showing will give a boost to Yugoslavia's new President, Vojislav Kostunica. He needs to consolidate his power so he can purge government ranks of Milosevic's corrupt cronies, prosecute the former President for fraud and abuse of power, and launch reforms to fix the country's ailing economy. But Kostunica is unlikely to ship Milosevic off to The Hague for prosecution for war crimes. That would look too much like caving in to the NATO powers that bombed Serbia during its war with Kosovo in 1999—even though Kostunica is now asking them for economic aid.

Meanwhile, Kostunica faces his own troubles with Kosovo: Militant ethnic Albanians who want independence recently killed four policemen in Serbia. Kostunica will have to walk a fine line: exercising restraint to avoid ruffling NATO troops stationed in Kosovo, even as he tries to maintain security on the Serbian-Kosovo border.

By Christopher Condon in Budapest