

3. Fault Lines in China's Economic Terrain

BETWEEN 1980 AND 2002 China's annual economic growth was 8.6 percent. Despite some fuzzy statistics, as well as ups and downs along the way, this remarkable record overshadows Japan's economic "miracle" of the 1970s and 1980s by nearly 75 percent: Japan's average annual growth in the 1970s and 1980s was 5 percent.

If China is able to sustain its growth at a rate similar to this recent history (its current rate is reported as 8.1 percent), its gross domestic product by 2025 would be only modestly below that of the United States, although its *per capita product* would still be less than 15 percent of that of the United States.

This rosy scenario confronts an array of potential "fault lines"—obstacles that could seriously hinder or even reverse this trajectory. Eight potential fault lines are especially serious. They impend in a wide range of differing sectoral and institutional areas, constituting serious obstacles to China's future growth. These

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fault lines, together with rough estimates of how much they would reduce China's annual economic growth, can be briefly described as follows:

- *Unemployment, poverty, and social unrest* Open and disguised unemployment in China amounts to more than 20 percent of the total labor force, or approximately 170 million people. Recent and prospective increases in unemployment are due to population increases in the 1980s, privatization and downsizing of inefficient state-owned enterprises, and the employment effects of China's efforts to comply with its WTO commitments. Rural poverty is accompanied by increased income inequality between rural and urban areas, by rural-to-urban migration, by rising urban unemployment, and social unrest. A possible worsening of these adversities could cause a reduction of between 0.3 and 0.8 percent in China's annual growth during the coming decade.
- *Corruption* Pervasive and perhaps increased corruption in China could adversely affect China's economic growth by distorting resource allocations, though how large these distortions would be is difficult to estimate. In cross-country comparisons, increases in corruption are associated with lower rates of economic growth. Were corrupt practices in China to worsen, China's position would decline in the country indexes that link economic growth with a prevalence of corruption. Such an adverse shift could reduce China's expected annual growth rate by perhaps 0.5 percent.
- *HIV/AIDS* Various estimates place the prevalence of HIV/AIDS at between 600,000 and 1.3 million, with an annual rate of increase between 20 and 30 percent! Plausible projections of these trends would seriously affect China's economic growth through the costs of treatment and through reductions in factor productivity and per capita output. In "inter-

mediate” rather than “pessimistic” scenarios, annual deaths from HIV/AIDS would be between 1.7 and 2.7 million in the second decade of the twenty-first century, cumulating by 2020 to more than 20 million and associated with annual reductions in China's GDP growth of between 1.8 and 2.2 percent in the period from 2003 to 2015.

- *Water resources and pollution* China is beset by a maldistribution of natural water supplies. North China, with more than 33 percent of China's population, and at least an equivalent share of its GDP, has only 7.5 percent of naturally available water. South China typically has an abundance of water, sometimes accompanied by serious floods. Pollution discharges from industrial and other sources aggravate the water shortage for consumers and industry in the North. Whether China's policymakers push for less efficient, capital-intensive water transfer projects from South to North or opt for more efficient recycling as well as conservation of water supplies in the North, will significantly affect future growth. Resolving this allocation issue is complicated by political considerations involving the relative influence of provinces in the North and the South. If economically inefficient policy decisions are made, China's expected GDP growth would be reduced by 1.5 to 1.9 percent in the coming decade.
- *Energy consumption and prices* China has shifted from being a net exporter of oil in the early 1990s to importing nearly half its oil and nearly a fifth of its natural gas. The major risk posed for China's sustained growth in the energy sector, however, does not depend on its increased oil imports but on the prices at which oil and natural gas are available. If there were a major and sustained contraction in global oil supplies and a sharp increase in oil and gas prices lasting for a decade, the bottom-line effect on China's annual growth would be a reduction of between 1.2 and 1.4 percent.

- *Fragility of the financial system and state-owned enterprises* The fragility of China's state-dominated financial institutions is suggested by the high volume of nonperforming loans (NPLs) on the balance sheets of China's four major state banks that are a result of "policy lending" by the state banks to loss-incurring state-owned enterprises. Estimates of total NPLs vary enormously, but they may amount to more than 60 percent of China's GDP. Under not implausible circumstances, China could experience a panic run on the banks, large-scale capital flight, a significant reduction in savings, and a sharp decline in capital formation. The ensuing financial crisis and credit squeeze could lower annual GDP growth by at least 0.5 to 1.0 percent.
- *Possible shrinkage of foreign direct investment* In the past fifteen years China has experienced a steadily rising volume of annual direct foreign investment (FDI), reaching \$50 billion in 2002, significantly boosting China's economic growth. Although a high volume of FDI may continue in the future, there are plausible internal as well as external circumstances under which it might contract. Adverse *internal* developments include possible future tensions following the so-far smooth leadership succession, the possibility of internal financial crisis, and the inconvertibility of the renminbi (RMB); *external* impedance might result from improvements in the investment climate in Eastern Europe, Russia, Indonesia, India, and other countries that compete with China for foreign capital. A recent RAND study estimated that a reduction of \$10 billion a year in FDI may be associated with an expected reduction of China's annual GDP growth of between 0.6 percent and 1.6 percent.
- *Conflictual adversities: Taiwan and other potential conflicts* Although the status quo in cross-strait relations between

China and Taiwan is broadly beneficial to the People's Republic of China, Taiwan, and the United States, tensions could escalate into possible conflict in the future, with growth-inhibiting consequences for China's resource allocations, exchange rates, and equity markets. The bottom line of these adverse developments could be a decline in China's annual growth of between 1.0 and 1.3 percent.

Were all of these adversities to occur, China's annual growth would be reduced between 7.4 percent and 10.7 percent, resulting in negative numbers for China's economic performance as a whole. Although the probability that all of these would occur is extremely low, the probability that none will ensue is also low. Moreover, the probability that several of them might cluster is higher than their joint probabilities would suggest because of interdependencies among them. For example, an internal financial crisis would likely have negative impacts on foreign direct investment, on unemployment, and on corruption.

The ramifications of these eight fault lines are likely to extend into all levels of China's society, government, and party structure. To mitigate the ensuing stresses will demand an enormous and continuing set of consultations, negotiations, and transactions among China's central and provincial governments and its party apparatus. This demanding process will probably preoccupy China's new collective leadership during the next decade, predisposing it to avoid external distractions and perhaps especially to maintain equitable relations with the United States.

POSTAUDIT

The eight fault lines remain but, like those in California's tectonic plates, have not shown signs of near-term eruption.