

# Fault Lines in China's Economic Terrain<sup>1</sup>

---

## SUMMARY

---

This report addresses the following key question: What are the major challenges, fault lines, and potential adversities (these terms are used synonymously), that China's economic development will encounter over the next decade, and how severe an impact on China's overall economic performance will ensue if these adversities occur separately or in clusters? Thus, we deliberately concentrate on what might go seriously awry in the economy and, in the process, slow or even reverse China's double-digit growth rates in the 1980's and high single-digit growth in the 1990's and the early part of the 21<sup>st</sup> century. We do not devote equivalent attention to the means by which China might prevent, mitigate, or remedy these adversities. Nor do we consider the potential sources of resilience and strength that could offset or absorb these adversities.

This asymmetry is deliberate. Its intent is to provide a countervailing perspective to what has been a generally prevailing consensus, with a few notable exceptions, that China's economy will be able to sustain high rates of economic growth for the indefinite future.

In considering what might go seriously wrong in the Chinese economy we have focused on eight domains, summarized below. For each, we estimate a "bottom-line" in terms of expected effects on China's annual growth rate over the next decade, drawing on a variety of methods, models, and judgments to make these estimates. Most of the problems that we examine are ones that China has confronted in the past and, notwithstanding, has managed with sufficient success to sustain high rates of economic growth. Consequently, our focus is on whether and by how much these adversities might be worsened in the future, and with what effects.

Our principal findings together with estimates about the corresponding "bottom-lines" can be summarized as follows:

### **UNEMPLOYMENT, POVERTY, SOCIAL UNREST**

Open and disguised unemployment in China amounts to something in the neighborhood of about 23 percent of the total labor force, or approximately 170 million. Recent and prospective increases in unemployment have been principally due to population increases in the 1980's, and the privatization and downsizing of the often inefficient, loss incurring state-owned enterprises. China's efforts to comply with its WTO commitments may engender more unemployment. Rural poverty has led to increased income inequality between rural and urban areas, rural-to-urban migration, rising urban unemployment, and social unrest.

Potential worsening of these adversities may cause a reduction between 0.3-0.8 percent in China's annual growth rate in the coming decade as a result of lower factor productivity, lower savings, and reduced capital formation.

---

<sup>1</sup> This is a summary of a recently published RAND book entitled, "*Fault Lines in China's Economic Terrain*" by Charles Wolf, Jr., K. C. Yeh, Benjamin Zycher, Nicholas Eberstadt, and Sung-Ho Lee. MR-1686 NA/SRF, 2003.

### **ECONOMIC EFFECTS OF CORRUPTION**

To calibrate corruption in China and to link it to China's expected economic performance, we have drawn on two established indices of corruption and their association with differing quintile positions in annual economic growth rates of the various countries included in the indices. Were corrupt practices in China to increase – as a result of plausible though not demonstrable recent trends – the result would be to lower China's position in the quintile distribution linking economic growth with the prevalence of corrupt practices.

The result of this adverse shift would be a reduction of about 0.5 percent in China's expected annual growth rate.

### **HIV-AIDS AND EPIDEMIC DISEASE**

Estimates by the United Nations and other sources place the prevalence of HIV-AIDS between 600,000 and 1.3 million, with an approximate annual rate of increase between 20-30 percent per year! To analyze the effects of possible further deterioration, the effects of several scenarios are simulated which include varying estimates of the costs of therapy, the impacts of disease on factor productivity, and on per capita output. The bottom-line estimate for the "intermediate" rather than "pessimistic" scenarios is a trajectory of annual deaths from HIV-AIDS between 1.7 and 2.7 million a year in the second decade of the 21<sup>st</sup> century, cumulating by 2020 to over 20 million casualties, and associated with annual reductions in GDP growth between 1.8 percent and 2.2 percent in the period from 2002 and 2015.

### **WATER RESOURCES AND POLLUTION**

China is beset by a perennial maldistribution of natural water supplies. The North China plain, with over a third of China's population and at least an equivalent share of its GDP, has only 7.5 percent of the naturally available water resources. Subsurface aquifers in North China are near exhaustion and pollution discharges from industrial and other sources further aggravate the shortage of water for consumers and industry. By contrast, South China normally has an abundance of natural water supplies, sometimes leading to serious floods. The dilemma this poses for China's policy makers is whether to push for capital-intensive water transfer projects from South to North, or to emphasize recycling as well as conservation of water supplies in the North. This key allocation issue is further complicated by political considerations relating to the relative influence of provinces in the North and South.

We examine several different scenarios involving different combinations of water-transfer projects and recycling/conservation efforts intended to reduce the stringencies in water resource availability in the North. For various reasons, non-optimal policy decisions and resource allocations might be pursued. A plausible but adverse scenario would result in a reduction of China's annual GDP growth between 1.5 and 1.6 percent in the ensuing decade.

### **ENERGY CONSUMPTION AND PRICES**

One risk posed for China's sustained high growth is the availability of oil and natural gas supplies at what might be sharply increased world energy prices. Price changes constitute the main risk, rather than China's shift from being a net exporter of oil in the early 1990's to a situation in which nearly half of its oil and nearly a fifth of its natural gas consumption are derived from imports.

To analyze this potential adversity, we consider several scenarios in which there a drastic contraction in global oil supplies by about 25 percent lasting for a decade between 2005-2015.

The several scenarios consider a range of plausible demand elasticities, together with allowance for increased energy efficiency, resulting in a conservative estimate of increased global oil prices by as much as three-fold.

The resulting bottom-line effect on China's annual growth rate resulting from a "moderately severe" scenario during the period from 2005-2015 would be an average diminution between 1.2 and 1.4 percent.

#### **FRAGILITY OF THE FINANCIAL SYSTEM AND STATE-OWNED ENTERPRISES**

One salient indicator of the fragility of China's state-dominated financial institutions is the extraordinarily high rate of non-performing loans on the balance sheets of the four major state banks. NPLs have risen and continue to rise as a result of accumulated "policy lending" from the state banks to loss-incurring state-owned enterprises. Estimates of total NPLs cover an enormous range between 9 percent and 60 percent of China's GDP: the correct figure is more likely to be at the upper end of this range.

Under various plausible circumstances, China could experience a panic "run" of withdrawals from the state 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 plausibly reduce total factor productivity by 0.3 percent, with an accompanying reduction in the annual rates of growth of capital stock and of employment that would collectively lower annual GDP growth by 0.5 to 1.0 percent

#### **POSSIBLE SHRINKAGE OF FOREIGN DIRECT INVESTMENT**

Between 1985-2001, foreign direct investment in China rose from an annual rate of about \$2 billion to over \$40 billion in 2001, in constant 1995 dollars. Analysts both within and outside China agree that FDI has been of considerable importance and has had leveraging effects for China's high rates of real economic growth, although there is considerable disagreement about the mechanisms that account for these leveraging effects.

High rates of FDI may well continue in the future, but there are also not implausible circumstances under which this FDI might severely contract. These adverse circumstances include both possible internal developments (such as tensions accompanying the leadership succession, the possibility of internal financial crisis, inconvertibility of the RMB, and slow implementation of China's WTO pledges), as well as possible external developments (such as improvements in the economic infrastructure and investment climate in other competing countries and regions in Eastern Europe, Russia, India, and elsewhere). To a greater extent than in the past, future FDI in China will depend critically on the comparative risk-adjusted-after-tax-return on investment in China compared with that of other countries.

Based on very rough assumptions and using three plausible but admittedly imprecise methods, our preliminary calculations suggest that a sustained reduction of \$10 billion a year in FDI may be associated with an expected reduction of China's annual GDP growth between 0.6 percent and 1.6 percent.

#### **CONFLICTUAL ADVERSITIES: TAIWAN AND OTHER POTENTIAL CONFLICTS**

The status quo in the perennial troubled relationship between China and Taiwan entails major benefits for the PRC, Taiwan, and the United States. However, there are also significant risks and tensions associated with the status quo. It is not inconceivable that these tensions might erupt into possible conflict between the PRC and Taiwan.

We consider one scenario involving escalation from what Beijing might view as provocation by Taiwan, a blockade imposed by the PRC in response, tangible though limited coercive force to effectuate the blockade, and the resulting effects on China's stock markets, exchange rates, and reallocations of resources to military spending, with ensuing reductions in the rate of growth of the civil capital stock and in total factor productivity.

The bottom-line of these adverse developments would be a decline in China's annual rate of economic growth conservatively estimated at between 1.0 - 1.3 percent.

Table S.1 summarizes our rough estimates of the potential impacts on China's annual real economic growth that could ensue from each of the several adversities or fault lines, were they to occur separately on a one-at-a-time basis.

**Table S.1**  
**Impacts on China's Growth Arising from Separate Fault Lines**  
**2005-2015 (Preliminary)**

Types of Setback	Separate Effects Diminishing China's Economic Performance (percent/year)
Unemployment, Poverty, Social Unrest	0.3 - 0.8
Economic Effects of Corruption	0.5
HIV-AIDS and Epidemic Disease	1.8 - 2.2
Water Resources and Pollution	1.5 - 1.6
Energy Consumption and Prices	1.2 - 1.4
China's Fragile Financial System and the State-Owned Enterprises	0.5 - 1.0
Possible Shrinkage of Foreign Direct Investment	0.6 - 1.6
Taiwan and Other Potential Conflicts	1.0 - 1.3

The probability that none of these individual setbacks will occur is low, while the probability that all will occur is still lower. Were all of them to occur, our estimates indicate that China's growth would be reduced between 8 percent and 10.6 percent annually, thus registering negative numbers for China's economic performance as a whole. While the probability that all will occur is very low, the probability that several will ensue is higher than their joint probabilities would normally imply. The reason is that their individual probabilities are not independent of one another; the occurrence of one or two will raise the probability that others will ensue. Because of these interdependencies, it is highly likely that several of the separate adversities would tend to cluster if any one of them occurs. As examples: an internal financial crisis would have serious negative impacts on the relative attractiveness of foreign investment in China, conducting to shrinkage of FDI; epidemic disease would intensify water pollution problems and would discourage foreign investment.

Table S.2 suggests some of the key interdependencies among the several fault lines we have discussed.

**Table S.2  
Interdependencies among Fault Lines\***

Cause Consequence	Unemployment, Poverty, & Social Unrest	Economic Effects of Corruption	HIV-AIDS and Epidemic Disease	Water Resources and Pollution	Energy Consumption and Prices	China's Fragile Financial System and State-Owned Enterprises	Possible Shrinkage of Foreign Direct Investment	Taiwan and Other Potential Conflicts
Unemployment, Poverty and Social Unrest	/	X	X	X	X	X		
Economic Effects of Corruption	X	/				X	X	
HIV-AIDS and Epidemic Disease	X		/	X	X			
Water Resources and Pollution	X		X	/	X			
Energy Consumption and Prices	X				/			
China's Fragile Financial System and the Possibility of Internal Financial Crisis	X	X	X			/	X	X
Possible Shrinkage of Foreign Direct Investment	X	X	X			X	/	X
Taiwan and Other Potential Conflicts								/

\* X's indicate where each fault line (column headings) is likely to affect the occurrence and/or severity of others (row headings).