

Fault Lines in China's Economic Terrain

Remarks for National Bank of Poland conference:
“Successes and Failures in Catching Up”

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RAND/CWjr/lb

Roadmap

- Background
 - China's economic record, and the consensus forecast
- Key questions and qualifying remarks
- “Fault Lines in China's Economic Terrain”, published July 2003 (8 fault-lines, 4 co-authors)

Background (1): China's Economic Performance

- From late 1970s to 2002: average annual growth: 8.6%
- Despite fuzzy statistics and ups-and-downs, this record exceeds Japan's "miracle" of 1970's and 1980's growth: ~ 5%
- If China can sustain such high growth, GDP by 2025 only modestly below U.S.
 - although per capita product only ~ 15% of U.S.

Background (2): Consensus Forecasts (av. %/yr)

- Current range, 2003-2015: 5-8
- Some specific forecasts:
 - China's SSB/CASS/CAS 8.0
 - CCP 7.2
 - IMF 7-8
 - Large U.S. Bank 7.8
 - Pooled multinational businesses 7.8
 - EIU 7.5
 - CIA 7.0
 - World Bank 6.9
 - ADB 6.6
 - RAND 5.0

Key Questions

- What major “fault lines” (“adversities”) might seriously affect China’s ability to sustain rapid economic growth?
- How might these adversities occur, and by how much would they affect China’s growth?

Introductory Remarks

- major “fault lines” (8) are illustrative, not exhaustive
- most have been confronted by China in past two decades and adequately managed, analysis focuses on possible worsening
- analysis hasn’t considered China’s resources, policies, and adaptability to prevent or alleviate adversities
- analysis is “one-at-a-time”, but also some consideration of “clustering”
- “bottom-line” uses standard RAND model and other methods to estimate reduced GDP growth rates in 2003-2015 period; estimates very uncertain, but generally as likely to be low as high!

What Might Go Wrong: Eight Fault Lines (1)

1. Unemployment, rural poverty, social unrest

- open and disguised: 170M, 23 % rate (1999)
- possible worsening: population increases 1980s, SOEs' downsizing, WTO effects, growing income inequality
- bottom-line: reduced GDP growth by 0.3-0.8 %/yr

2. Economic effects of corruption

- method of estimation: inter-country indexes of corruption, and of GDP growth; Professor Hu's data and research
- bottom-line: reduced growth by 0.5%/yr

Fault Lines (2)

3. HIV/AIDS and epidemic disease (separate SARS chart)
 - prevalence: 600K-1.3M, $\Delta = 20-30\%/yr!$ (UN), alternative scenarios: 11-80 million carriers by 2015!
 - costs of therapy: \$600/person/yr ~ \$7-48B/yr by 2010
 - bottom-line: reduced growth by 1.8-2.2%/yr
4. Water resources and pollution
 - shortages in North China plain, aquifers near exhaustion, pollution aggravates shortages
 - south-north transfer projects vs. conservation/recycling
 - bottom-line: adverse scenario, reduced growth by 1.5-1.9%/yr
5. Energy consumption and prices
 - consumption increasing slowly, imports more so
 - adverse scenario assumes 25% drop in global supply, 3-fold price increase 2005-10
 - bottom-line: 1.2-1.4%/yr reduced GDP growth

SARS: Some Observations

- reported cases in China: 5,326, 63% of global (HK 21%, Taiwan, 8%), (WHO, 6/16/03)
 - deaths: China 6.5% of cases (HK 17%, Taiwan 12%, Singapore 15%, Canada 13%)
 - data anomalies
- comparisons with HIV-AIDS:
 - scale and mortality rates SARS \lesssim HIV-AIDS
 - costs of therapy \lesssim HIV-AIDS (unless SARS pandemic)
 - but, SARS contagion \gtrsim HIV-AIDS
- effects on capital formation, FDI, productivity, GDP growth are negative, but magnitudes and duration uncertain

Fault Lines (3)

6. Financial fragility and SOEs

- NPLs ~ 40% of GDP and rising, fragile bank balance sheets
- possible bank “runs”, capital flight, lower S and I, etc.
- bottom-line: 0.5-1.0%/yr reduced growth

7. Possible shrinkage of FDI

- from 1985-2001, real FDI increased by 19%/yr, from \$2B to over \$40B; large effects through various mechanisms
- possible internal and external sources of shrinkage
- bottom-line: each \$10B shrinkage → 0.6-1.6%/yr reduced GDP growth

Fault Lines (4)

8. Possible military conflicts

- Taiwan (repeat and escalation from 1996 cross-Strait crisis), South China Sea disputes, Senkaku/Diayou Islands, Korean peninsula, India
- bottom-line: (based on Taiwan scenario): 1.0-1.3%/yr growth reduction

Concluding Remarks (1): Summary Results

Effects on China's Growth of Separate Adversities, 2005-2015	
<i>Types of Adversity</i>	<i>Separate Effects on China's Economic Performance (%/yr)</i>
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	– (1.5-1.9)
Energy Consumption and Prices	– (1.2-1.4)
China's Fragile Financial System, SOEs, and Possible Financial Crisis	– (0.5-1.0)
Possible Shrinkage of Foreign Direct Investment	– (0.6-1.6)
Potential Military Conflicts	– (1.0-1.3)

***N.B.:** Probability that none will occur is low, probability that all will occur is even lower, but interdependencies*

Concluding Remarks (2): Possible Clustering

Interdependencies Among Adversities*								
Cause	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, SOEs, and Possible Financial Crisis	Possible Shrinkage of FDI	Potential Military Conflicts
Consequence								
Unemployment, Poverty, Social Unrest	/	X	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	/				
Energy Consumption and Prices					/			X
China's Fragile Financial System, SOEs, and Possible Financial Crisis	X	X	X		X	/	X	X
Possible Shrinkage of FDI	X	X	X			X	/	X
Potential Military Conflicts								/

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

Concluding Remarks (3): Some Generalizations

- Sustaining China's high growth rates confronts major challenges in coming decade
- While most of these have been adequately managed in the past, some could seriously worsen in future.
- Highly unlikely that all will worsen, but also unlikely that none will do so
 - possible clustering with large potential impacts on GDP growth
- Broad implications: character of these challenges (“fault lines”) will preoccupy top Chinese leadership, strongly disposing them toward:
 - avoiding external distractions,
 - equitable relations with U.S.