

# 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

<b>Interdependencies Among Adversities*</b>								
<b>Cause</b>	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
<b>Consequence</b>								
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.