
**POTENTIAL ADVERSITIES CONFRONTING CHINA'S
CONTINUED ECONOMIC GROWTH**

Widely divergent views about China's future are prevalent among policymakers, politicians, pundits, business people, analysts, and academics. Prominent among the questions on which their views diverge are the following:

1. At what rates and for how long will China continue its rapid economic growth of the past two decades?¹
2. What are the major challenges, fault lines, and potential adversities (the terms are used synonymously in this study) that China's economic development will encounter in the next decade, and how much of an impact on its economic performance will these have if they occur separately or in clusters?
3. How will the rate of China's economic growth affect the pace and content of its military modernization?²

¹The U.S.-China Security Review Commission in its hearings and final report in 2002 generally displayed a consensus view that high rates of economic growth in China would continue for the foreseeable future. See *Compilation of Hearings Held Before the U.S.-China Security Review Commission, 107th Congress First and Second Sessions, Fiscal Years 2001 and 2002*, U.S. Government Printing Office, Washington, D.C., 2002; also available from U.S.-China Security Review Commission, www.uscc.gov. For a sharply divergent although distinctly minority view among putative experts on China, see Gordon Chang, *The Coming Collapse of China*, Random House, New York, 2001.

²The wide range of differing views on both questions 3 and 4 are evident in the report of the U.S.-China Security Review Commission, see *Report to Congress of the U.S.-China Security Review Commission—The National Security Implications of the Economic Relationship Between the United States and China*, July 2002, especially pp. 167–

4. Is China's sustained rapid growth beneficial or harmful to U.S. national economic and security interests?³

These questions are large, complex, and interrelated. From a U.S. policy perspective, the answer to question 4, if it were convincing, would constitute a sort of "bottom line." Whether continued high growth is beneficial to U.S. interests depends in considerable measure on whether one adheres to the view that political pluralism, democratization, and benign rather than aggressive Chinese foreign and defense policy are helped, hindered, or not affected by high rather than low rates of growth. Moreover, embedded in this question are other questions relating to the probabilities associated with these outcomes, and how these probabilities would be affected by high rather than low growth. Even strong advocates of the positive, benign view of the effect of economic growth would not—or at least *should not*—impute certainty to the connective links between economic and political change. The phenomena and the linkages among them are, as Winston Churchill once observed about the Soviet Union's behavior, "a riddle wrapped in a mystery inside an enigma."

In this study of aspects of China's future, we focus principally on the second question mentioned above: What are the major potential adversities, or fault lines, confronting China's economic development over the next decade, and how much would these adversities affect China's economic performance? We do not address directly the first question of "how long," or indeed "whether," China will sustain high growth. Although inferences with respect to answering question 1 might be drawn from the data and analysis provided in our effort to answer question 2, these inferences would not be warranted. The

178 on The Defense Budget and China's Military Economy. Although the commission acknowledges the possibly benign aspects of China's continued economic growth, the predominant view conveyed by the report places more emphasis on the malign and possibly threatening facets of this growth. For example, note the following statement issued by commission member and former president of the U.S. steel workers George Becker when the report was published:

Unless our country changes course, the tragic fact that China's resurgence is being financed by U.S. firms at the expense of American workers will one day be seen as the first stage in China's strategy of asserting its industrial preeminence over us (Office of Commissioner Becker, Press Release, July 15, 2002).

³U.S.-China Security Review Commission, especially pp. 1–2, 4–5.

reason for avoiding such inferences is that we have not attempted to assess the opportunities, instruments, and policies that China might be able to utilize to sustain its growth by offsetting the serious “adversities” that are the focus of this study. Thus, we do not address the sources of resilience and strength as possible counters to Chinese economic fault lines—countervailing elements that include, for example, the expanded resources generated by China’s rapid and sustained economic growth, which provide additional means for addressing and redressing the adversities discussed in this study.

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—among policymakers, businessmen, and scholars both within and outside China: namely, that China’s economy will be able to sustain high rates of economic growth for the indefinite future. This consensus is, for example, reflected in analyses and forecasts by the World Bank, the Organisation for Economic Co-operation and Development (OECD), the Institute for International Economics, and in the hearings and final report of the U.S.-China Security Review Commission.⁴

In considering what might go seriously wrong in the Chinese economy, we have focused on eight domains, described in Chapters Two–Nine. For each of them, we have tried to arrive at a bottom line in terms of their respective effects on China’s annual growth rate should each of these adversities occur. To arrive at each bottom line, we have used the aggregate growth model employed in other RAND work on the Chinese and other Asian economies (Wolf et al., 2000) or through other methods and calculations tailored to and described in each of the eight separate chapters.

The adversities that may confront China over the next decade cover a wide range of possibilities. These may be categorized as *institutional and structural* (e.g., rural and urban unemployment, poverty, and corruption), *sectoral* (e.g., HIV/AIDS and epidemic disease, water resources and pollution, and energy), *financial* (e.g., internal financial crisis and shrinkage of foreign direct investment), and *security* (e.g.,

⁴See reference reports, memoranda, and other papers published by these organizations.

military tension and conflict in the Taiwan Strait and other parts of the Asia-Pacific region).

China has confronted in the past two decades five of the eight fault lines that we consider (unemployment, corruption, water resources problems, HIV/AIDS, and financial fragility) and, nonetheless, has sustained high rates of economic growth. Hence, in assessing the potential impact on China's future economic performance of these fault lines, our focus is on whether, why, and by how much their intensities may increase—that is, on *changes*, rather than on the prevailing *levels* of each fault line. For the other three fault lines that have not previously occurred or recurred—oil price shock, foreign direct investment (FDI) shrinkage, and serious military conflicts—we consider the circumstances under which they arise and their resulting economic effects.

While the potential adversities that we address are formidable, they are by no means an exhaustive list. For example, we do not address the possibility of internal political strife that might ensue in the leadership succession and transition from the *so-called* 4th-generation leadership (i.e., Jiang Zemin and his septuagenarian associates) to the 3rd-generation leadership (Hu Jintao and his sexagenarian associates). Nor do we address the effects of a possible intensification of economic disparities between the relatively rich eastern provinces and the impoverished western ones. And we do not consider the possibility that internal economic barriers among China's 37 provinces and special administrative regions might grow, thereby obstructing the operation of markets and hindering efficient resource allocation. While these omissions are touched on in several of the chapters, they are not addressed in detail. Thus, what we cover is a selective, rather than exhaustive, set of adversities.

Figure 1.1 depicts these adversities and how each would affect China's economic performance.

Tier IV of Figure 1.1 shows the numerous fault lines that already loom large among the problems that China faces, and that may loom even larger in the future. The successive chapters focus on empirical data to quantify each of the selected adversities. In most cases, we

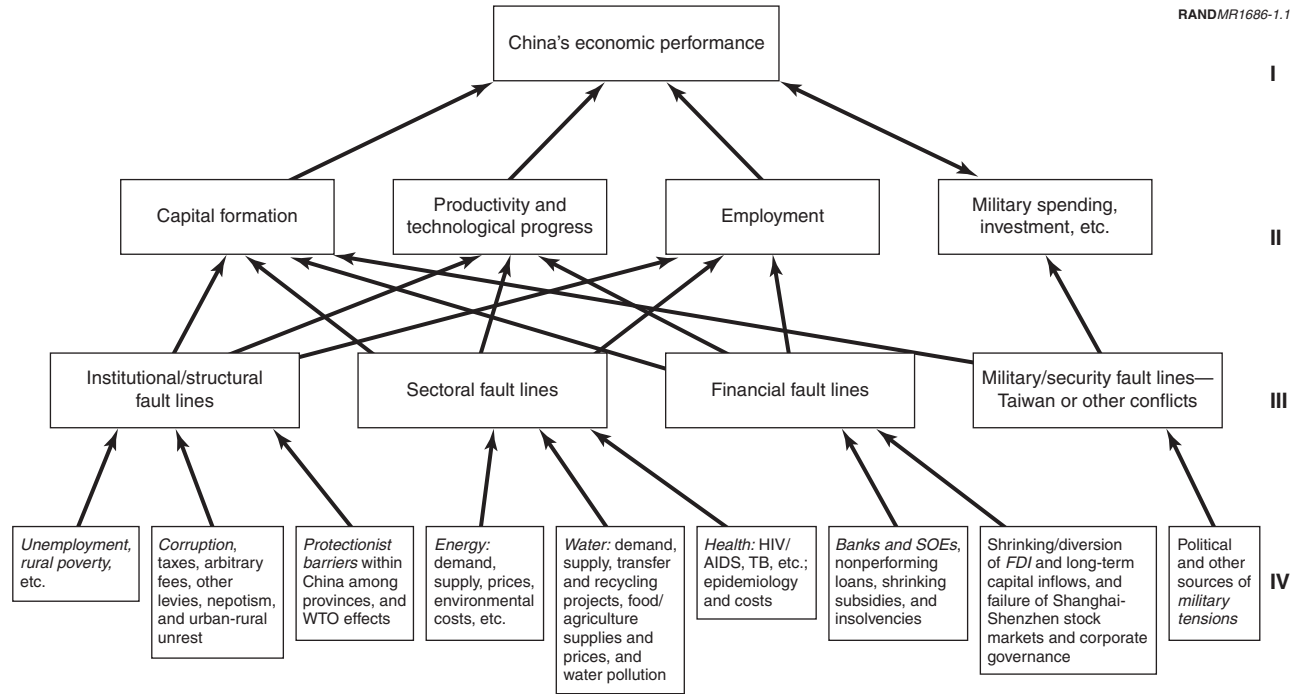


Figure 1.1—Fault Lines in China's Economic Terrain

use “severe” rather than “worst-case” scenarios to assess quantitatively the separate consequences that would follow from, respectively, high unemployment and rural poverty, the economic costs of corruption, water resource problems and pollution, HIV/AIDS and epidemic disease, increased energy prices, possible internal financial crisis, a shrinkage of foreign direct investment, and security tensions in the Taiwan Strait and elsewhere in the region.

Tier III of Figure 1.1 provides a rough categorization of these separate fault lines in terms of the institutional, sectoral, financial, and security categories mentioned above.

Tier II summarizes the standard model that we sometimes use in this study and have used in prior studies⁵ to evaluate the separate effects on China's aggregate economic performance (Tier I) that would ensue from each of these adversities. In evaluating the effects on economic growth, we apply the standard model in several instances (e.g., to assess the effects of increased unemployment, water and pollution difficulties, financial crisis, and possible military conflict in the Taiwan Strait). For several other adversities, we use regression models, alternative scenarios, and other methods described in the corresponding chapters to derive rough estimates of potential effects on China's economic growth.

A possible bias is introduced into our analysis because the method we use assesses the effects of each adversity separately from the effects of others. This “one-at-a-time” procedure implies that the probabilities of their occurrence are independent of one another, when in fact many of them are interdependent. Although we do not assign prior probabilities to each of the adversities, it can be inferred that the probability that *none* of them will occur is low, and the probability that *all* will occur is still lower.⁶ However, the probability that several will occur is higher than their joint probabilities would normally imply, because of their interdependence. For example, it is rea-

⁵See Wolf et al., 2000, especially Appendix A, where the standard model is explained in detail.

⁶This assertion is based on the arguable but reasonable assumption that each of the separate adversities has a prior probability associated with it of less than 0.5—say, between 0.1 and 0.2.

sonable to presume that rural and urban unemployment, poverty, and the incidence of HIV/AIDS and other epidemic diseases will tend to cluster—poverty is likely to be associated with higher incidence of epidemic disease, and disease is likely to aggravate poverty. There is a similar linkage between possible internal financial crisis and the shrinkage of foreign direct investment. Furthermore, the prior probabilities of internal financial crisis and shrinkage of foreign direct investment would be significantly increased if military tensions or conflicts occurred in the Taiwan Strait.

In sum, the adversities that we address in the body of this book are more likely to occur in clusters of interrelated and hence interdependent adversities, rather than separately in a one-at-a-time mode.

The eight fault lines that we address are grouped into three parts: Part I, China's Institutional and Structural Fault Lines (Chapter Two, Massive Unemployment and Rural Poverty, Chapter Three, Economic Effects of Corruption); Part II, Sectoral Fault Lines (Chapter Four, Epidemic Disease: A Wild Card in China's Economic Future? Chapter Five, Water Resources and Pollution, and Chapter Six, GDP Effects of an Energy Price Shock); Part III, Financial Fault Lines (Chapter Seven, China's Fragile Financial System and the State-Owned Enterprises, Chapter Eight, Possible Shrinkage of Foreign Capital Inflows); and Part IV, Security Fault Lines (Chapter Nine, Taiwan and Other Potential Conflicts).

Finally, Chapter Ten summarizes the principal findings of the preceding chapters and presents our conclusions. These conclusions can be summarized at a very general level as follows: Each of the potential adversities that we have examined entails a consequential risk of reducing the very high, single-digit growth of real gross domestic product (GDP) that China has sustained over the past 20 years. Moreover, if these adversities occur in clusters that reflect their interrelationships and interdependencies, China's economic picture would indeed become dark. The following chapters provide the data and analysis that lead to this broad conclusion.