L21 Occasional Paper Series: BEYOND THE BEIJING OLYMPICS - REASSESSING CHINA'S FUTURE

China has averaged double digit growth each year for over three decades and its economy has grown four times in size over this period. Now the second largest economy in the world (by PPP measurement,) its story is one of the greatest stories of economic success in history. Granting Beijing the Olympics confirmed China's rise but also gave it the right to showcase its achievements to the world. It was not by accident that Beijing insisted on the longest Olympic round the world torch relay in history – a full 130 days.

Instead, perhaps unfairly, the Beijing bound Olympic torch became a focal point for widespread international political criticism of China. Criticism began during the March crackdown of protesters in Tibet but spread to encompass more general criticism of China's one-party politics, poor human-rights record, and even its economic system. Following the earthquake in Sichuan Province in May, attention was drawn to the poorly enforced standards that led to its 'tofu' buildings collapsing when the earthquake hit Sichuan province – allegedly a symptom of the corruption that runs rampant throughout its economic setup. The country's inefficient use of resources, particularly energy, was previously highlighted as China became the world's heaviest polluter in terms of CO_2 emissions and stories emerged about how Olympic athletes in Beijing would suffer from the smog. There are concerns that China's generally inefficient economic system will have difficulty coping with inflation levels - the highest for a generation. From being a new and alternative model of successful development, the Chinese system has become, momentarily at least, unattractive again.

The severity of the crackdown on Tibetan protesters or the existence of corrupt building practices in China does not indicate anything that most China watchers would not already know about the country. China today is much more open than it has ever been and its leaders are much more open about the country's problems than they have ever been. In a conversation with an official from China's vast State Council Information Office (which regulates the promotion of China through its media) last November, the official compared China to a large, dysfunctional family. Such a family could go outside its home to a restaurant for dinner and appear normal, functional, and well-heeled. But invite guests to its home and appearances would be much more difficult to manage. The metaphor is well taken. Hosting the Games means that the realities of (and tensions within) Chinese economy, society and politics will be scrutinized closer than ever before – sometimes accurately and fairly, and other times not.

This paper will look at the major economic and social tensions within China. Many analysts tend to simply produce a laundry list of the successes and shortcomings within China, see which side of the ledger appear the more compelling, and fall on the side of either optimism or pessimism accordingly. In this paper, I will highlight the most serious problems within the country. But importantly, I will offer reasons *why* I believe China's problems are *worsening* and why it will be difficult and even unlikely that the country can solve them without the prospect of enormous turmoil.

Behind China's economic miracle

China began the reform period with a set of challenges that Western societies are no longer familiar with, namely an undeveloped economy with a primarily rural population and a backward industrial sector. Since these reforms began under Deng Xiaoping in 1978, China's economy has quadrupled in size. Hundreds of millions have been lifted out of poverty. Across the country, it builds a city the size of Brisbane every month. Private enterprise accounted for around 2 percent of output in 1979. Now it is about 70 percent. Statistics like these understandably give cause for optimism.

The common argument is that China abandoned central planning for the free market and that 'capitalism with Chinese characteristics' is working well. We need to rethink these arguments. At the National People's Congress in March 2007, the annual meeting of the State's highest body, current Premier Wen Jiabao offered his country a warning, declaring that "the biggest problem with China's economy is that growth is unstable, unbalanced, uncoordinated and unsustainable." This was all but reiterated by President Hu Jintao at the five-yearly Congress in Beijing in October 2007, and repeated again this year. Similar warnings have been issued since the late 1990s.

Growth remains robust but it tells only a small part of the story and how China is faring. There are serious flaws to the Chinese economic growth strategy emerging, particularly since the 1990s. Indeed, in recent times, its high level of growth is somewhat symptomatic of the problem.

According to a recent IMF study, 75 percent of China's growth over the past decade comes from capital investment,[1] although it dropped to around 50 percent in 2007. In other words, growth is largely the result of pouring money into investment projects. Fixed asset investment increased by over 25 percent in 2005 and 24.8 percent in 2007. In the first quarter of 2008, it jumped a further 25 percent.[2] Investment bank Morgan Stanley estimated that fixed asset investment probably exceeded US$1.3 trillion in 2006.[3] In 2007, it was US$1.9 trillion.[4] The state (through state-owned banks) directed well over half of this and still owns almost 60 percent of fixed capital assets in the country. They do so in order for the Chinese Communist Party (CCP) to retain its economic relevance – a must for any authoritarian regime wanting to remain in power. The CCP's role in China's economy means that it still controls and dispenses the most valued economic, professional and career opportunities in Chinese society. This would be an acceptable strategy provided that capital is used efficiently and productively. Unfortunately, this is not the case.

Let's begin with the bad loans problem which has been manifest since the early 1990s. The Chinese are famed for their level of savings. The country's consumption as a proportion of GDP is around one third –

the lowest of any major economy in the world. Its people save about 30-40 percent of their income – largely to provide for themselves in old age - and almost all of it is deposited into state owned banks since there are few alternatives. China's economic treasure chest and its economic growth are built on the back of these savings. According to China's Ministry of Finance statistics, the financial assets of banks constitute about 98 percent of China's total financial assets. Four big state owned banks alone control about 70 percent of these assets. Only about 2 percent of financial assets are held in private or foreign owned institutions.

Worryingly, but for bail-outs and recapitalizations through floating a minority share of equity in these businesses, China's main banks have been technically insolvent for over a decade being weighed down by non-performing-loans (NPLs). In 2006, accounting firm Ernst & Young estimated total NPLs in the financial system at US$911 billion – about 40 percent of GDP. These banks are only able to operate due to periodic bail-outs by the government (in which bad loans are transferred to 'asset management companies') and access to continued liquidity only due to the high savings of the population being deposited in these banks. This problem has been deteriorating for a decade. Why?

Loan recipients – of which 70 percent are state owned enterprises (SOEs) – cannot pay back a huge proportion of their loans. World Bank findings indicated that about one third of recent investments made were wasted.[5] In the 1980s and 1990s it took $2-$3 of new investment to produce $1 of additional growth. Studies from the last several years show that it now takes over $4 to produce $1 of additional growth. Recent reports suggested that it was more like $6 invested for $1 of additional growth[6] - which is twice as inefficient compared to the Mao Zedong era. In other words, Chinese investment is getting less and less bang for its buck. Why is it taking more and more money to achieve the same level of growth?

China is suffering the effects of massive and chronic 'overinvestment', over-capacity, and declining productivity. It is estimated that while nine out of ten manufactured goods were in oversupply in 2004, investment in fixed assets grew by 30 percent over the same period and contributed 47 percent of GDP.[7] In 2005, Wang Xiaoguang from Beijing's Macro Economic Research Institute of the National Development and Reform Commission warned that China would continue to face oversupply problems for the next few years.[8] Regardless, investment in fixed assets is now over 50 percent of GDP. In other words, increasingly large amounts of money are being poured into the building and production of things that are not consumed or needed by the economy or its people. For example, this is reflected in the average levels of slow moving inventory in Chinese firms which are estimated to take around 350-360 days to sell[9] and the levels of unsalable inventory which are possibly the highest in the world. This is a symptom of overinvestment and produces growth figures that are bulked up by 'assets' that will never be used or consumed.

Quite clearly, capital allocation (in the form of credit and 'subsidies') has frequently little to do with rational economic decision making. As mention, 70 percent of China's capital is reserved for SOEs although these SOEs produce less than 30 percent of the country's output. SOEs operate in around a dozen of the most important and highly protected sectors – such as banking, finance, insurance, construction, infrastructure, telecommunications and media. According to one expert, 19 percent of SOEs were unprofitable in 1978, 40 percent were unprofitable in 1997, rising to 51 percent being unprofitable in 2006.[10] A conservatively estimated 40 percent of bank loans to SOEs are extended on a 'policy' rather than 'commercial' basis while most loans to SOEs are afforded artificially low interest rates.[11] An estimated two thirds of NPLs were loans given on a 'policy' basis. Banks are effectively fulfilling the political priorities of the government through their 'policy lending' function: to maintain jobs for SOE workers who are the Party's most loyal supporters, to maintain support for SOE managers who are core Party members and supporters, and to maintain growth in 'middle class' areas at any cost since the Party needs the continual support of the new and emerging middle classes to survive. As Zhang Hanya, a senior researcher at Beijing's National Development and Reform Commission's Investment Research Institute admitted last year, China needs to keep fixed investment growth levels at around 25 percent per annum just to *maintain* present levels of employment.[12]

The central leadership is well aware of these problems. The warnings they issued about the Chinese economic model is evidence that they do not have their proverbial heads in the sand. Yet, while these problems worsen, these warnings have been issued periodically and with increasing frequency over the past two decades. The tendency to waste capital and protecting inefficient SOEs is accelerating. In many respects, China's model is that of 'state corporatism' rather than private enterprise. More and more of China's national wealth is being directed by the state toward inefficient projects to fulfill political objectives. Meanwhile, for these same political reasons, reform of the country's key economic institutions – its banking sector in particular – has made little progress.

Recent instances of reform have been largely tactical to plug obvious holes rather than comprehensive. Even for the piecemeal reform that has occurred, it runs into the enormous problem of poor or non-existent implementation. Western experts visiting China generally go away impressed with the competency of its senior officials. But functional authority in China is largely decentralized. Around 35-40 million provincial and local officials exist in a largely unaccountable environment due to the lack of effective institutions for public accountability within the one-Party set-up. These officials oversee, regulate, and administer almost all economic and enforcement activity in the country. China's central leaders have consistently run into problems in terms of enforcing its mandates and regulations. For example, no matter how urgent the calls from central officials to exercise 'discretion' in lending policies, local officials who oversee bank branches continue to lend to inefficient SOEs in ever increasing amounts. As an illustration, the ratio of deposits banks are obligated to hold has already been raised five times this year by the Chinese Central Bank in desperate attempts to lower lending levels. It was raised seven times in 2007, and multiple times since 2000. Yet, local officials have largely ignored this requirement through dubious accounting and reporting, while loan levels have increased by 25 percent year on year during the same period.

This leads to the enormous problem of corruption which is systematic, profound and embedded throughout every level of Chinese economy and society. One Chinese economist, Hu Angang, calculated that the cost of corruption is up to 17 percent of GDP in the 1990s and has remained at similar levels and perhaps worsened since. But it is not just the economic costs. Embedded corruption prevents the implementation of top-down reform, weakens the collective will to undertake it, and leads to social dysfunctions that are pervasive and difficult to resolve. Yet, China's central leaders have little choice but to continue to support local officials in order to prolong the survival of the CCP as rulers. In a vast country of 1.3 billion people, Beijing relies on the 35-40 million local Party officials to represent its authority and preserve the CCP's interests. Local CCP leaders have a huge informational advantage over the central leadership who has few alternate sources of information other than what local authorities reveal. Importantly, even national law, economic and even social order policies are necessarily executed by local officials.

These problems are some that go to the heart of whether the Chinese model of economy growth is sustainable. They are neither just cyclical or a temporary hitch as China confronts the enormous task of development but are *systemic*. Critically, economic problems are one side of the coin; the other is its effects on Chinese society. It is the uncertainty of how these economic and social problems and tensions will play out that cause China's leaders to be apprehensive.

Between success and turmoil - tensions in Chinese society

There have really been two reform periods since 1978. The first period involved allowing peasants to use their land in any way they chose (even if they were never granted ownership of it) and sell their products at market prices after meeting production quotas. There was also the encouragement of mass migration from rural to urban areas, paving the way for rapid industrialization and a move away from exclusive reliance on subsistence agriculture. Significantly, little political power was sacrificed by the CCP during this period, lasting from 1978 until the mid 1980s. This first phase was also undoubtedly successful. Indeed, the World Bank estimates that 80 percent of the Chinese that emerged out of poverty did so in the first decade of reform, not more recently as many assume.

The second period of reform from the mid 1980s onwards has been more problematic because genuinely transforming a modernizing economy threatens the CCP's hold on power. The response of the Party has been to hold on to the levers of economic power as much as possible, access national resources for political purposes, and attempt to reform only those aspects of the economy that do not threaten its political power. Remaining the major economic player in the economy allows the CCP to reinvent legitimacy to rule based on its capacity to generate prosperity, rather than on any ideology. One-Party rule will not be questioned so long as the Party can deliver prosperity to the masses.

There are several serious flaws to this strategy, the consequences of which could be painful and unpredictable for Chinese society and politics.

First, as I argue above, there must be serious doubts placed on the longer-term sustainability of China's state-led development model. Further reforms desperately needed would require the CCP to relinquish its control over the country's resources; something unlikely to occur without significant upheaval forcing the CCP's hand. Moreover, the building of much needed institutions within society and economy – transparent and even-handed tribunals and courts, rule of law, systems of public accountability, and so on – will similarly proceed slowly under the current political structure.

Second, state-led development strategy tends to breed a dependence on the state in capital and labour, exacerbating inequality since a relatively small number of well-connected insiders disproportionately benefit.[13] Indeed, within one generation, China has gone from being the most equal to the least equal society in Asia. Its Gini coefficient (a measurement of income inequality) is now 0.47, up from 0.16 in the 1970s[14] and 0.39 in 2005. There are between 50-250 million middle-class people (depending on what definition you use), but around one billion people who are increasingly missing out on the benefits of economic growth. Over the past decade, around 400 million people have seen their net incomes decline.[15] Its leaders would know well an old Chinese proverb from Qing Dynasty times: “inequality, rather than want, is the cause of trouble.” Not that ‘want’ is conducive to stability either. According to the UN funded 2005 China Human Development Report, there are still up to 400 million people living in poverty (defined as living on US$1 or less.)

An obvious counterpoint here is that inequality is always inevitable once development takes off in a backward, agrarian society. However, the CCP has used vast resources to sponsor, co-opt, and in many respects create the middle classes. The great lesson of the 1989 Tiananmen protests for the CCP was that the Party was better off tying the futures of the middle classes to the future of the CCP, than it was isolating them. It is from the urban middle classes, after all, that any impetus for political reform is likely to come. Enormous national resources, especially capital, are directed toward nurturing the middle class in China’s cities and these middle classes have been the great beneficiaries of China’s state-led development model. This is reflected in the composition of the roughly 70 million CCP members. A third of these are businesspeople and entrepreneurs, a third are college students, and a quarter of these are professionals. Meanwhile, a massive underclass of up to a billion people is the downside of this strategy. It is not surprising that while middle class support for the CCP remains robust (while economic growth is strong anyhow) numerous internal Party studies show that support for the CCP in the poorer rural areas, in particular, is extremely poor.

Third, the massive misallocation of the country’s wealth combined with the entrenched corruption of officials is having ‘real’ economic and social effects. For example, independent studies suggest that unemployment is around 10-20 percent in urban areas and 20-40 percent in rural areas. In 2002, consultants McKinsey & Co released a report stating that China’s ‘pay as you go’ pension pools were on the verge of bankruptcy; not surprising as the system is based on (state) employers making enough profit to meet these obligations. Although Chinese officials suggest a US$100-200 billion problem, others like the World Bank and Lehman Brothers investment bank put it at about US$1 trillion in 2002.[16] Since then it has undoubtedly got worse. A far off, but enormously critical juncture, will be reached in 2030 when a quarter of the population will be over 60 (around 350 million) compared to just 10 percent currently.

Furthermore, reported significant instances of ‘mass’ social unrest (defined as involving 15 or more people) have grown from a few thousand in the early 1990s to 87,000 instances in 2005 according to official figures. A Hong Kong based study believed that the figure in 2003 was closer to 300,000.[17] The vast majority of these protests are directed toward local officials for grievances against such things as illegal land seizures and taxes, mismanagement of the local environment either because of incompetence or collusion with well-connected industries, and the obvious misappropriation of public funds for personal use.

Conclusion

How these social and economic dysfunctions will play out remains unclear. Since 2000, the leadership has repeatedly singled out domestic unrest as the greatest threat to the regime and promoting a 'harmonious society' as its top priority. Since 2000, when these objectives officially became the highest priority, the situation continues to worsen. Moreover, it is highly likely that it will continue to deteriorate since the CCP cannot change course without significantly relinquishing its role in Chinese economy and society and risk losing its hold on the reins of power.

Beyond the expected speed humps that any developing country might confront, few Western analysts predict a systematic slowdown for the Chinese economy. Fewer still predict stagnation, turmoil, and even chaos ahead. From the outside looking in, China as a success story has been a compelling one. As we approach the Beijing Olympics and with the country under much more intense scrutiny, taking a closer look from the 'inside' may just cause many of us to reevaluate the degree of optimism with respect to China's future.

China's future is largely out of external hands and in the hands of the Chinese. The main strategy of the CCP for China has been for China to grow its way out of trouble. Its leadership realizes that its execution of this strategy is in trouble and takes very seriously the possibility that China could stagnate and descend into turmoil. We would do well to equally seriously consider this possibility ourselves and take heed.

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[1] Paul Heytens & Harm Zebregs, "How fast can China grow?", in *China – Competing in the global economy*, ed. Wanda Tseng and Markus Rodlauer, (New York: IMF, 2003).
[2] "Fixed asset investment up 24.6% in Q1", *Xinhua*, 16 April 2008.
[3] Stephen Roach, "Scale and the Chinese Policy Challenge," *Global Economic Forum* (New York: Morgan Stanley, 19 June, 2006).
[4] "China's fixed investment up 24.8% in 2007", *Xinhua*, 24 January 2008.
[5] See Minxin Pei, "How Rotten Politics Feeds a Bad Loan Crunch in China", *The Financial Times*, 7 May 2006, p 9.
[6] Andy Xie, "Running out of room to stimulate", 3 January 2002: http://www.chinaonline.com; McKinsey & Co Global Institute, reproduced in Diana Farrell & Susan Lund, Putting China's Capital to Work (New York: McKinsey Global Institute, 2006).
[7] See *The Economist*, 18 March, 2004. A report in 2002 by James Kynge suggested that in that period, 80 percent of manufactured products were in chronic oversupply: "China's changing of the guard halts key reforms", *The Financial Times*, 7 September 2002, p 4.

[8] "Experts: China facing oversupply, deflation," *Xinhua*, 2 December 2005.
[9] See Gordon Chang, *Statement to U.S.-China Economic and Security Review Commission*, (Washington DC, 22 August, 2006).
[10] See Usha Haley, *Statement before the US-China Economic & Security Review* (Washington DC, April 4, 2006.)
[11] See Nicholas Lardy, "China's Worsening Debts'", *The Financial Times*, 22 June 2001, p 13.
[12] "China 2007 investment may rise 25%", *China Daily*, April 29, 2007.
[13] See Eva Bellin, *Stalled Democracy: Capital, Labor, and the Paradox of State-sponsored Development* (Ithaca: Cornell University Press, 2002).
[14] A Gini coefficient of zero represents perfect income equality, while a coefficient of one represents perfect income inequality.
[15] See Statement by Dr. Joshua Muldavin, *Major Internal Challenges Facing the Chinese Leadership*, US-China Economic and Security Review Commission, 2-3 February 2006.
[16] Alastair Newton and Robert Subbaraman, "China: Gigantic Possibilities, Present Realities," *Lehmann Brothers Research Report*, 21 January 2002.
[17] See David Murphy, "The Dangers of too Much Success," *Far Eastern Economic Review*, 10 June 2004; Dexter Roberts, "China: A Workers' State Helping the Workers?" *Business Week*, 13 December 2004.