

## **Economic benefits for all?**

### **Internal Problems and their effects on the economic and political emergence of China**

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The world appears to be mesmerized by China's unstoppable rise as a global power. But it may be premature to conclude that China will continue its awesome growth regardless of the potential difficulties ahead. In this brief presentation, I will outline many of the well-known problems in the Chinese economy and society and warn against assuming that China's growth will continue if these problems remain unresolved.

**Economic imbalances:** The Chinese economy is not a picture of health even though it has achieved close to 10 percent of economic growth per year for the last few years. The savings rate is too high (almost 45 percent of GDP) while consumption is too low (household consumption is slightly less than 40 percent of GDP). High savings rate fuels excessive investment in fixed assets (about 42 percent of GDP in 2005). Such excessive investment rate contributes to overcapacity in many industries, such as steel, automobile, and cement. Overcapacity also leads to excessive reliance on exports since the domestic markets cannot absorb the output from new capacities. This increases China's trade imbalances with the rest of the world. China's current account surplus in 2006 is expected to reach \$150 billion or 8 percent of GDP, an unprecedented figure for China. Thus, domestic imbalances spill over into the external markets, causing trade frictions with China's major trading partners. Relying on fixed investment at home and exports abroad now drives Chinese economic growth. Clearly this trend is not sustainable. Under this model, current growth is high, but is achieved at high costs. For example, overinvestment in fixed assets is made at the expense of underinvestment in public goods, such as health, environment protection, and education.

**Social consequences of economic imbalances:** Such imbalances directly affect Chinese society. Underinvestment in public goods directly contributes to rising inequality, social discontent, and environmental decay. For example, access to health care has been declining steadily even as China grows richer. Today, only 1 in 3 Chinese has health insurance; half of the people who get sick cannot afford to see a doctor. Poor health is the leading cause of poverty in rural areas. Unfortunately, the state has abdicated its responsibility in ensuring access to healthcare. For example, the government accounts for only 17 percent of health spending in China. The degradation of the environment is likely to be the most serious stumbling block for China in the decade ahead. With two-thirds of its rivers severely polluted, the country, already short of water, may face a serious water shortage, which will in turn force a slowdown in economic growth. Estimates show that various pollution costs China roughly 10 percent of GDP per year, in terms of loss of natural resources, future

expenditures to treat pollution, healthcare costs, and premature deaths. Thus, if we apply strict green accounting, China may be said to have grown, not at 10 percent a year, but at zero percent. Obviously, underinvestment in health and education will hurt the accumulation of human capital for the future, threatening to undermine the potential of the Chinese economy.

The political causes of imbalances: As we all know, economic and social imbalances not only reflect, but also are caused by, imbalances of political power. In the Chinese case, severe and growing economic and social imbalances are the result of the lack of democratic reforms that would have redistributed political power from the state to civil society and thus made the government more accountable to its people. The reality, of course, is very different. While China has grown richer and more integrated into the global economy, its political system has remained essentially Leninist, controlled by a one-party state unwilling to cede its political monopoly. Today, political power is overconcentrated in the hands of political and economic elites. The social base of the ruling party is no longer that of the working class or the peasantry, but that of various elite groups, such as professionals, bureaucrats, and new capitalists. From this perspective, it is not surprising that public policy would serve the interests of the elite groups, but not the underprivileged. Another cause of the social and economic imbalances is the perverse incentive structure embedded in the governance system. Because the ruling elites do not have to answer to the public, they have no incentive to provide adequate public goods. In the meantime, they are held responsible for delivering visible results of economic growth by their bureaucratic superiors. As a result, they have all the incentives to invest scarce financial resources in tangible physical assets (the surest way to demonstrate their abilities). Obviously, the net result is an imbalance between fixed asset investments (excessive) and social investments (inadequate). As long as such political imbalances remain uncorrected, it will be hard to correct the economic and social imbalances.

How Beijing is responding to the imbalances: The Chinese government has clearly recognized these imbalances and begun to be very concerned. Their rhetoric on social harmony clearly reflects such concerns. In the area of public policy, there are signs that the government has taken small steps toward correcting the imbalances, such as abolishing an onerous tax in the rural areas and announcing increases in health and education spendings in the countryside. But steps appear to be inadequate, as recent studies show that the actual increase in government spending that directly benefits the disadvantaged is very limited. So the challenge for the Chinese is to match its rhetoric with real action.

How will the internal problems affect China's economic and political emergence? These internal imbalances will have serious long-term consequences. Externally, internal economic imbalances have already created rising trade frictions with major trading partners, especially the U.S. and E.U. Because China's development model is extremely resource-intensive (due to an over-reliance on manufacturing), China will have an ever-growing demand for raw materials, which will cause concerns around the world and even bring China into competition with the West for such materials, especially energy, in volatile regions such as Africa and the Middle East. The worsening environmental degradation in China will have global consequences as well. In particular, China's greenhouse emissions, estimated to surpass those

of the U.S. by 2009, will likely become another point of contention between China and the West. Internally, growing imbalances will have negative political, economic, and social consequences. Politically, facing, rising tensions between the state and society, the government will feel increasingly insecure and likely respond with greater repression and political control. This would cause a vicious cycle as political reform is further delayed and tensions rise as a response. Economically, imbalances could lead to a major crisis, mainly manifested in the banking system a few years from now. This could be caused by another round of massive bad loans made to finance excess capacity and inflated property developments. The inefficient capital allocation system will undermine long-term efficiency and growth prospects. Socially, rising inequality, poor public services, and environmental decay will slow down growth as well, in addition to fueling discontent.

These problems are not insurmountable. But tackling them requires political courage and enormous financial resources. It is clear that China has the financial means to address these challenges. The question is whether its leadership has the political commitment and vision.

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