A Worst-Case Scenario for China

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If it gets this bad, lock up your spoons and womenfolk

Even with the outlook for the world economy rapidly worsening, many economists are still relatively optimistic about the prospects for the Chinese economy next year. While the International Monetary Fund recently lowered its forecast for 2009 real GDP growth to 5 percent, the World Bank is expecting 7.5 percent. This was also the consensus estimate of professional forecasters surveyed earlier this month by Frankfurt-based Dekabank. Wang Tong-san, a spokesperson for the Chinese Academy of Social Sciences, was even more upbeat at a recent press conference, telling reporters he expected 9 percent, or even a bit more, and putting the likelihood of this prediction at “better than 70 percent.”

Speaking at the opening of the fifth US-China Strategic Economic Dialogue on December 4, China’s central bank governor Zhou Xiao-chuan sounded a more pessimistic note, however, warning that China must prepare for the “worst case scenario.” While he didn’t elaborate, it’s easy to see what he’s worried about. If the sharp slowdown in exports and investment that is now showing up in the monthly statistics continues next year, the 8 percent growth believed to be necessary to keep unemployment under control will be difficult to achieve.

To answer the question of how bad things could get in 2009 we might start by considering a repeat of the net exports crash and fiscal stimulus that followed the 1997 Asia crisis as a base case. In this scenario, real gross domestic product growth could slow to as little as 4.5 percent. While in 1999, the worst Asia crisis year for China, growth only fell to 7.8 percent, the drop in net exports experienced 10 years ago would have much more severe consequences today because of the Chinese economy’s increased reliance on foreign trade.

The question then becomes how much the recently announced Rmb4 trillion fiscal stimulus package could boost GDP above this base-case level, which already includes the 1-2 percentage points such policies are believed to have contributed in 1999. National Development and Reform Commission Minister Zhang Ping has put the contribution from this stimulus at only 1 percentage point per year, implying no increase over our base case at all. And even the 2 percentage-point impact that many private-sector economists are looking for would at most raise this base-case forecast by only 1 percentage point. Thus 5.5 percent growth would seem to be about all that could be hoped for.

The problem, of course, is that now, unlike in 1999, the whole world is in crisis. Even 5.5 percent growth looks like more of a best case than a worst case scenario. In the worst case scenario, growth will be close to zero or even negative, which would have serious implications for employment and social stability.

Zero percent

In 1998, consumption accounted for 60 percent of nominal GDP (as calculated by the expenditure method); investment, 36 percent; and net exports, 4 percent. In 1999, these three components grew at 8 percent, 5 percent, and -35 percent, respectively, resulting in nominal GDP growth of 5.2 percent. (Real GDP growth was higher that year due to deflation.)

A rerun of those 1999 growth rates, but starting from the current GDP component shares—with consumption now accounting for 49 percent of GDP; investment, 42 percent; and net exports, 9 percent—would result in nominal GDP growth of only 2.9 percent. (The effects of a fiscal stimulus equivalent to the one in 1999 are captured in the '99 consumption and investment growth rates as both include government spending.) Even if we also assume a repeat of the 1-2 percent deflation of the late 1990s, so that next year's base case real GDP grew at, say, 4.5 percent, allowing for an additional one percentage point fiscal stimulus only gets you to 5.5 percent.

To expect something more than this, you'd have to believe that either the fiscal stimulus would contribute a lot more to growth than the NDRC says it will or that there will be a big turnaround in the world economy next year. As there is no reason to doubt the NDRC's analysis of the stimulus package and all the evidence we have so far suggests that the global slowdown is worsening rather than abating, neither of these possibilities seems particularly likely.

On the other hand, plenty of downside is possible. Private sector investment, for example, could easily fall next year in response to the ongoing contraction in real estate and manufacturing and the excess capacity that has been evident for some time in sectors such as steel, cement, and auto manufacturing. (In 2007, Hebei Province alone produced 107 million tons of steel, more than any country except Japan.) Government investment will presumably grow rapidly as a result of the stimulus plan, but there is no guarantee that this can entirely compensate for a slowdown in the private sector.

Zero percent investment growth is certainly not out of the question and this would imply only 0.8 percent nominal GDP growth in our base case scenario. And if the GDP deflator next year were in the range of October's 4 percent CPI inflation, real GDP would shrink for the first time since the beginning of the 'reform and opening' period in 1978. (The GDP deflator is a measure of inflation used to adjust nominal GDP growth for the effects of price changes.)

Bankruptcy free-for-all

Recent news from Guangdong, which, because of its dependence on foreign trade has seen the most severe downturn so far, paints a grim picture of what this worst case scenario might be like. The province, long one of China's most prosperous, is now experiencing a property crash, widespread bankruptcies, and massive job losses.

The situation appears to be worst in Dongguan, a manufacturing center in the Pearl River Delta located about two hours north of Hong Kong. Anywhere from a quarter to a third of the city's factories, which produce a variety of labor-intensive products ranging from toys to computer mice, are now believed to have closed—victims not only of the global recession but also of rising costs, changes in export-tax rebate policy, currency appreciation, and, in the case of the toy factories, product-safety concerns.

The situation is particularly chaotic due to the lack of any kind of orderly bankruptcy procedure.

Typically owners simply abscond with whatever is left of the company cash to homes in Hong Kong or Taiwan, setting off a scramble among unpaid suppliers and employees to loot whatever is left in the factory. In some cases parts of factory buildings have been dismantled and taken away, leaving banks with practically worthless collateral. According to a post from the end of last month on the website of the pro-democracy magazine Beijing Spring, some creditors have even recruited members of the People's Armed Police or the army to seize assets at gunpoint.

It is estimated that as many as 800,000 jobs have been lost in Dongguan this year, resulting in a massive reverse migration from the city back to the countryside. At the nearest rail hub in Guangzhou, the large crowds typical of the Chinese New Year holiday can now be seen every day as the newly unemployed make their way home.

Last month one group of workers avoided the long lines at the train station and made the front page of the Chongqing Evening News by travelling from Dongguan to their hometown in Szechuan province on motorcycles, which they had managed to salvage from their plastics factory after the owner disappeared without paying them. Converting the vehicles into miniature mobile homes, they covered three thousand kilometers in ten days—an odyssey strangely reminiscent of the Dust Bowl exodus of the 1930's, when bankrupt farmers made the (somewhat shorter) trip from Oklahoma to California in broken-down Hudsons and Model 'T' Fords.

Sudden flare-ups

Indeed the number of such travelers nationwide could soon far exceed the 2.5 million people that fled the Dust Bowl in the largest US precedent for this kind of large-scale economic migration. Some believe that as much as 20 percent of China's floating population of something like 120 million workers could lose their jobs. This implies a staggering 24 million people out of work, far more than any conceivable fiscal stimulus projects could possibly absorb. (Studies have shown that a one percentage point stimulus can create about one million jobs.)

Like the 'Okies' of 70 years ago, the unemployed face a bleak future once they reach their destinations. There is hardly enough land in the countryside to support even the existing rural population, let alone large numbers of new arrivals, many of whom have in any case spent their entire working lives in industry or construction and know little about farming. While the government has announced a plan to stimulate rural spending with subsidies for electronic goods, these people are more likely to need free food and clothing than deals on mobile phones and washing machines.

Local officials will have a critical role to play in responding to this crisis, but their record even in the best of times inspires little confidence that things will go smoothly. Even the official weekly Observer (Liao Wang), in an editorial on "mass incidents" published at the end of last month, criticized "the Party committees and grassroots level of government of some localities" for "responding slowly, misjudging things and handling them poorly, resulting in minor things being delayed, while major things explode."

It seems that the central government is under no illusions about the potential for an escalation of protests and riots as the economy worsens. In an effort to prepare for this eventuality, the Central Party School in Beijing is even arranging a special seven-day course for two thousand county-level party secretaries, who will be attending in groups of five hundred. Two topics will be covered: "maintaining social stability" and "handling sudden flare-ups " (tufa shijian de chuli).

_Winds of change

You might think a global downturn that originated in the US would have relatively little impact on China. In fact, however, the historical record suggests that events originating overseas can sometimes have profoundly destabilizing effects on the Chinese political order.

A study published in the November 7 edition of the journal Science shows that climactic change thousands of kilometers to the south may have led to the overthrow of three of China's greatest dynasties. The authors found that the final years of the Tang, Yuan, and Ming dynasties all coincided with failures of the summer monsoon, which normally brings rain from the Indian Ocean to the northern and western provinces. (Ominously, the monsoon began to weaken again in the late twentieth century.)

Could economic headwinds from across the Pacific have a similar effect on the Middle Kingdom today?

Consistently high economic growth since 1978 might be thought of as confirming a 'mandate of heaven' for China's present-day leaders in much the same way as good harvests once did for imperial rulers. If the professional economists are right and GDP grows at 7.5 percent or more next year, this mandate will be stronger than ever. But in the worst case scenario, a lot more than the economy will be at stake.

P.S.

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