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China's Future Growth: WTO Accession & SARS

Now that China has achieved World Trade Organisation (WTO) membership, and the new leadership is in place, China seems well placed to implement vital reforms. However, this is unlikely to happen overnight.

If recent history is any guide, China is due for a period of great change. Every ten years or so since the communists gained power, China has seen a significant shift of gear: famine caused by the Great Leap Forward; factional strife from the Cultural Revolution; and the economic reforms and anti-government demonstrations of 1989. And now we can see two signposts to the next milestone.

The first is China's entry to the World Trade Organisation (WTO), after 15 years of trying. Theoretically, this should provide the world with fantastic access to China's markets, and should also bind China to economic reforms in line with the rest of international business. Optimists believe it may ultimately make the country's secretive and undemocratic government more transparent and accountable. Pessimists believe it could increase unemployment and financial instability and quicken the collapse of the Communist Party.

The second is a potential series of leadership changes which could be the widest ranging of the past 20 years and could enable a transfer of power to a more politically open minded younger generation. It is also possible, though, that the new leadership may try to increase up its legitimacy by promoting nationalism and lead China into confrontation with Taiwan, the US and Japan. But it is true to say that we have rarely seen such divergent views on where China is heading.

That China has entered a key phase of its economic and political reforms is not in question. However, the hopes and fears raised by WTO accession, and the prospect of a new generation of leaders, are probably misplaced. The way in which the country is run is not likely to change as a consequence, at least not for some years. What will change China in the short term is the way in which it handles the final and most difficult phase of its reform. The potential for failure is likely to rise as the country's leaders become absorbed in the politics of succession. The consequence of failure may be the very upheaval that China has struggled to avoid since the events of 1989.

The terms of China's entry to the WTO are more far reaching than for any other new member. The terms require China to open previously guarded markets, such as banking, agriculture, telecommunications and insurance. For some sectors, lower trade barriers will cause a rise in unemployment. In other sectors, it will generate new job opportunities. However, tariff barriers are the least of China's concerns, which are currently one of the lowest for any developing country. More importantly, China must still introduce many changes before it can truly be called a market economy. Independently of the WTO, China must make these changes to ensure its partially-reformed economy does not collapse, and that it can maintain healthy economic growth. Even at the official growth rate of 7.3%, growth could not absorb the increasing ranks of the unemployed. Over the next 10 years, the country must generate 8m-9m new jobs per year (an increase from 5.5m-6.5m in the late 1990s).

However, average annual growth is expected to remain at approximately 7%, about 1.5% lower than the average for the second half of the 1990s.

Where China was once able to able to boost the economy by releasing sectors restrained by Maoist principles (agriculture, small private and enterprises of mixed ownership), it no longer has easy sources for new growth potential. China must now build a marketplace which deploys labour and capital more efficiently. Both are still inhibited by government interference. The country's state-owned banks, are technically insolvent thanks to politically inspired lending to sometimes loss-making state enterprises. Although in decline, the state sector is still key to the country's stability because it employs 45% of the urban workforce and also receives the majority of the state banks' loans.

The mechanisms that keep a market economy going, from public listings through to bankruptcies, are still bound by politics. A recent book on the business environment in China, by Joseph Studwell put the country's bankruptcy rate during the 1990s at no more than one in two thousand a year: twenty times less than the level in the US. The country's two stock markets remain the near exclusive preserve of state-owned enterprises. The majority of shares are held by the state or its employees, and ordinary shareholders have little influence over the way companies are run.

Continued high growth requires strong demand, yet the incomes of the majority of rural residents (65% of the population) have been stagnant for the last four years. The long-term solution will likely involve moving the large amount of surplus labour in the country (over 150m people) into other sectors. However, rural credit co-operatives, which were the usual source of funding for rural industries, are now bankrupt, and cities are unable to provide enough jobs even for their own population. China will continue to benefit from inflows of foreign investment, and as the global economy recovers, from improved export performance. But given China's size, the economy still relies on domestic sources of growth, which are experiencing problems. Growth over the past seven years has relied on huge government spending levels. As a result, the Chinese government's debt is rising quickly. Combined with the banks' bad loan problems and the state's massive pension liabilities, this may be a financial crisis in the making.

The full impact of Severe Acute Respiratory Syndrome (SARS) is still unknown but is bound to slow economic growth. In spite of this, China's economy will still grow far more quickly than most. It expanded by over 9% per year to the first quarter: its fastest for six years. Due to membership of WTO, and the increasing contribution made by its own consumers, the economy depends far less on the state, and as a result, China is also exerting unprecedented levels of influence over world trade.

In 2002, the combined value of China's imports and exports was $620 billion and accounted for nearly 5% of world trade – nearly double the figure for 1995. China's industries continue to grow with such speed, that their share of world trade is likely to make a comparable jump again over the next few years.

So is the rate of growth likely to last? A case can be made either way but the fundamental issue is the percentage of state verses privately owned business. The more China's economy depends on the private sector and the less on huge state spending, the faster it is likely to grow. The credit rating agency, Standard & Poor's, estimate that in the year 2000 the private sector accounted for approximately 40% of China’s industrial output. The effect on the economy and investment opportunities once that proportion rises above 50% is anyone’s guess.

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