

Can the Earth Support

The coming boom-bust cycle.

SCENARIO ONE:

China Dominates

The Chinese economy maintains rapid growth while the Japanese economy continues to under-perform.

SCENARIO TWO:

Both Languish

The economies of both China and Japan under-perform.

SCENARIO THREE:

Japan Turns the Tables

Japan recovers, China under-performs.

SCENARIO FOUR:

Both Boom

The economies of both China and Japan meet or surpass their respective growth targets.

In the hope of stimulating a lively debate, let us consider four scenarios for the economic performance through 2015–20 of China and Japan, relative to each other, and relative to appropriate growth paths for a developing and an industrialized economy—say 7 percent for China and 3 percent for Japan. The four scenarios to the left are followed by questions for discussion below.

Question: Which scenario would most seriously undermine the security status quo in Asia?

Answer: Scenario One.

Question: Which scenario would be worst from the viewpoint of global economic growth?

Answer: Scenario Two.

Question: Which scenario, by concentrating the world's resources in Asia, would most seriously threaten the U.S. position as the world's sole super power?

Answer: Scenario Four.

Question: Which scenario, therefore, might the United States see as the most desirable of the four?

Answer: Scenario Three.

Question: Which scenario is associated with the greatest country risk for China?

Answer: Scenario Three.

Question: Which scenario runs most contrary to the general prevailing mood of optimism on China and of pessimism on Japan?

Answer: Scenario Three.

Scenario Three thus emerges as perhaps the most intriguing—if not necessarily the most likely—of the four scenarios.

I have long argued that the first part of Scenario Three—sustained Japanese recovery—is not an impossibility. It is becoming more difficult as Japan's pop-

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Chinese Growth?

BY TADASHI NAKAMAE



ulation ages and shrinks. Nevertheless, given deregulation and higher interest rates, Japan can still turn things around.

In support of the second part of Scenario Three, I would like—in the role of devil’s advocate—to focus on two major downside risks for China; namely

- The risk that the Earth is simply not big enough to sustain rapid Chinese growth;
- The risk that, in the absence of a properly functioning market mechanism, investment-led growth will lead China into one boom-bust cycle after another, with each boom less sustainable than the previous one.

CAN THE EARTH SUPPORT CHINESE GROWTH?

The Chinese economy today is reminiscent of the Japanese economy in 1973, when the first oil crisis drove down Japan’s long-term growth rate from 10 percent to 4 percent. But Japan then was a small fish in a big pond. China now is a much bigger fish in a more overcrowded pond.

China’s total population is 1.3 billion (ten times that of Japan), of which around 900 million Chinese may be assumed to be of working age. If we assume a labor participation rate of 65 percent, then given that an industrializing economy normally requires around 20 percent of the working population to be employed in manufacturing, this raises the prospect of manufacturing employment in China amounting to 120 million workers—a staggering total when seen against the 80 million for all OECD countries combined.

An early warning sign of the “big fish in a small pond” problem was briefly seen during 2003 when, at the peak of the boom in Chinese infrastructure investment, the world did not seem to have enough resources of iron ore, copper, nickel, and other raw materials for China to gobble up.

Even at the peak of its post-war expansion, Japan never came near to creating such a global shortage of resources.

Chinese growth is liable to be constrained not only by such global shortages of industrial commodities, but also by the limits of its own natural and human resources.

Water is one great problem. The Yellow River is already dry for more than half the year. Water contamination, especially around Beijing, is becoming dire.

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How China's Boom-Bust Economy Is Reflected in Steel

Following the boom of 1993, China's net imports of steel hovered at one million tons per month until 2001. Net imports of steel took off again in 2002, to meet the demand from booming infrastructure investment. But steel imports are now falling sharply, signaling the end of the

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investment bubble. The big difference between today's plunge in net imports and the one in 1993–94 is that the current fall in imports is accompanied by a surge in exports. This reflects the fact that overall Chinese production capacity, following massive investment in the steel sector itself, is now bigger than that of Japan and the United States combined.

In the current adjustment phase, it is highly probable that China will be a net exporter of steel. This may be a sign of things to come: if the boom-bust pattern continues, during its bust periods China could turn from a net importer to a net exporter of industrial commodities, and therefore from an inflationary to a deflationary force in the global commodity market.

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Agricultural land is another great problem. Farmers working in the city send money home to build houses on what used to be farmland. In the suburbs of big cities, local governments create new industrial developments on what used to be farmland. While the stock of land available for food production is thus reduced, Chinese people are eating more meat, which, as a means of obtaining nutrition from the land, is many times less efficient than eating rice, grain, and vegetables.

The aging and shrinking of the population is yet another great problem for China—perhaps even more serious for China than for Japan, as the effects of the one-child policy begin to be felt.

CAN CHINA GO BEYOND BOOM AND BUST?

The Chinese way of economic development so far has been massive investment in infrastructure culminating in two or three years of boom, followed by six to eight years of relative bust, followed by another boom.

Thus, during the boom from 1991 to 1993, surging investment in infrastructure was accompanied by rapid inflation. This necessitated tightening measures, as a consequence of which year-on-year growth of fixed capital investment fell from over 50 percent in 1993 to less than 30 percent in 1994 and from there to just under 8 percent in 1997 (see table).

At the peak of the latest boom, in 2003, an influx of foreign capital and a corollary surge in money supply, compounded by speculative anticipation of a rise in value of the Chinese renminbi, caused year-on-year growth of fixed capital investment to climb to 23 percent.

What has been particularly significant during the latest upsurge in investment is the failure of consumption to underpin overall growth. In 1993, when the ratio of fixed capital investment to nominal GDP rose to 41.4 percent, consumption still accounted for 50 percent of GDP. In 2003 investment and consumption were more or less equal, at just over 44 percent. This is further ground to suspect that the boom of 2003 was not a sustainable resurgence but rather an investment-led bubble.

By type of investment, construction and real estate investment has been the largest contributor to investment growth. This reflects the dominant role that regional governments have played in new infrastructure investment. They have competed with each other to attract foreign companies by con-



Two workers walk past rolls of steel at a Baosteel production line in Shanghai.

China GDP

	Share			Year over year		
	Nominal GDP	Fixed Capital Formation	Private Consumption	Nominal GDP	Fixed Capital Formation	Private Consumption
1987	100.0%	32.9%	52.5%			
1988	100.0%	32.9%	54.4%	23.6%	23.6%	28.0%
1989	100.0%	27.1%	53.3%	14.0%	-6.2%	11.7%
1990	100.0%	26.8%	51.5%	10.5%	9.1%	6.9%
1991	100.0%	29.4%	51.1%	14.2%	25.5%	13.2%
1992	100.0%	34.5%	51.6%	19.6%	40.0%	20.8%
1993	100.0%	41.4%	50.0%	30.0%	56.1%	25.9%
1994	100.0%	37.5%	46.2%	43.4%	29.9%	32.7%
1995	100.0%	34.7%	46.1%	29.9%	20.4%	29.5%
1996	100.0%	34.0%	46.9%	17.3%	15.0%	19.3%
1997	100.0%	33.8%	46.8%	8.6%	7.8%	8.4%
1998	100.0%	35.3%	47.1%	5.2%	9.8%	5.9%
1999	100.0%	35.9%	47.9%	4.8%	6.7%	6.5%
2000	100.0%	36.5%	47.9%	9.0%	10.7%	9.1%
2001	100.0%	37.8%	47.2%	8.8%	12.8%	7.0%
2002	100.0%	40.1%	46.1%	8.1%	14.5%	5.7%
2003	100.0%	44.5%	44.8%	11.0%	23.0%	7.7%
04/1-6	100.0%	44.4%		16.3%	28.6%	

Source: Datastream, National Bureau of Statistics of China

structing large industrial zones with good transport and communication links, and by building new housing developments nearby.

If China's boom-and-bust pattern of economic growth continues in this way—led by investment practices which are often economically irrational and tainted with corruption—then the following nine-point version of Scenario Three may not be too far-fetched.

Diminishing Peaks

The peak of each new Chinese boom is lower than, or at best on a par with, the previous peak, first because the Earth does not

have enough resources to allow Chinese growth beyond that peak, and second because growth is not underpinned by consumption. China therefore struggles to maintain a long-term growth rate above the 5–7 percent range which, for the developing Chinese economy, represents stagnation. When growth falls below 7 percent, unemployment leaps up and corporate profitability plummets.

Inflation and Deflation

Each boom brings global shortages of raw materials, leading to commodity price inflation, and at the same time each boom

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adds to excess supply capacity, leading to final goods deflation. Each bust leads to deflation in both commodity and final goods prices. Overall, the inflationary impact of boom-bust growth is progressively outweighed by the deflationary impact.

Low Operating Rates; Low Profitability

A chronic excess of supply capacity—the result of regional governments competing with each other to attract foreign companies—causes operating rates to remain low in all but the most economically hyperactive periods. This makes it impossible for firms to make money except when the economy is overheating.

Political Strains

The stage is thus set for political conflict between local governors, bureaucrats, and businessmen, who wish local firms to be profitable, and the central government, which cannot allow inflation to go on accelerating and the trade balance to turn to deficit.

Financial Straits

When the central government moves to end a boom by tightening, bankruptcies of Chinese firms rise and bad loans increase. As a result, any progress by Chinese banks to shore up their balance sheets is erased.

Country Risk

For Japanese and U.S. companies and banks, the perceived risk of China-related investment grows. Particularly vulnerable are

automakers and other companies that have targeted the Chinese domestic market through direct investment, firms that export their products to China (and have accounts receivable), and financial institutions that extend loans to China.

Capital Flight

As loans to China turn sour, and as foreign operations in China become unprofitable, capital flight from China begins. Foreign companies begin to withdraw. Chinese companies diversify overseas. Capital flight accelerates as people sense approaching social and political upheaval.

The End of Communism

Conflicts between regional and central government, popular unrest and financial instability associated with the deteriorating economy, and the historical trend towards democracy, combine to make one-party rule untenable.

While China Falters, Japan Recovers

The negative effects on Japan's economy of upheaval in China are far outweighed by the positive effects of deregulation and higher interest rates. Thus, Japan's long-delayed shift to a more services-oriented economy gathers speed. With a new breed of entrepreneurs discovering at last that the true potential for growth lies with new and small service-providing businesses, Japan returns to a sustainable growth path of 3 percent. It thus defies the conventional wisdom and rounds off Scenario Three—Japan turns the tables. ◆