

The Future Economic Growth of China and Security in East Asia

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Summary

1. The Chinese economy has already shifted into middle development mode at a growth rate of about 5%, and is expected to continuously face difficulties in the short, medium and long term as outlined below. Accordingly, it is unlikely to reach its potential growth rate unless appropriate measures are taken.
2. Short-term problems (until around 2015): Since the 4-trillion-yuan investment program was introduced after the Lehman Shock, China has kept its high growth rate with large-scale investment in fixed assets. However, both corporate finance and financial markets have been pushed to the limit. It is therefore essential to slow investment, though it is highly likely that the growth rate will fail to reach 5% as a result.
3. Medium-term problems (until around 2020): Having passed the Lewisian turning point, China will see a hike in wages and prices. The country will enter a new phase in which development on a real basis will be necessary in order to raise productivity and added value faster than the hike in wages and prices. China needs to downsize its inefficient government/state-owned sector and shift the role of its public finance. However, it is likely that there will be strong resistance from powerful vested interests. Without effective outcomes, total factor productivity (TFP) will stall rather than becoming a driving force for future development, resulting in a drastic growth rate plunge by 2020.
4. Long-term problems (after 2020): The declining birth rate and aging population will accelerate beyond expectations, thereby expediting the shrinkage of the working population and the pool of savings as a funding source. As experienced in Japan, the potential growth rate of the Chinese economy will fail to reach 5% after 2020. The economy is expected to be severely tested.
5. As a result, China's rapid development will not continue, and the country may never overtake the US in terms of GDP. Due to sluggish economic growth, China will face various political and economic risks. Among these, the most significant is national financial failure due to huge potential liabilities such as pension funds and higher costs of social security for migrant farm workers.
6. The overestimation of China's economic expansion has had an extremely harmful effect on the country's diplomacy and security and on relations with neighboring countries. Since 2009 in the wake of the Lehman Shock, Chinese attitudes toward international affairs have changed significantly. Soaring confidence has fostered assertive attitudes in foreign affairs, and has led to a particular strengthening of the core interest policy by which no compromise is made on territorial issues regarding land and marine areas.
7. An exaggerated view of China's ongoing rapid economic growth has caused overreactions outside the country. Illusions stemming from erroneous views on this growth have affected people both inside and outside China, thereby heightening international tensions in East Asia. This unnecessary friction should be avoided.

1. OUTLOOK FOR THE CHINESE ECONOMY

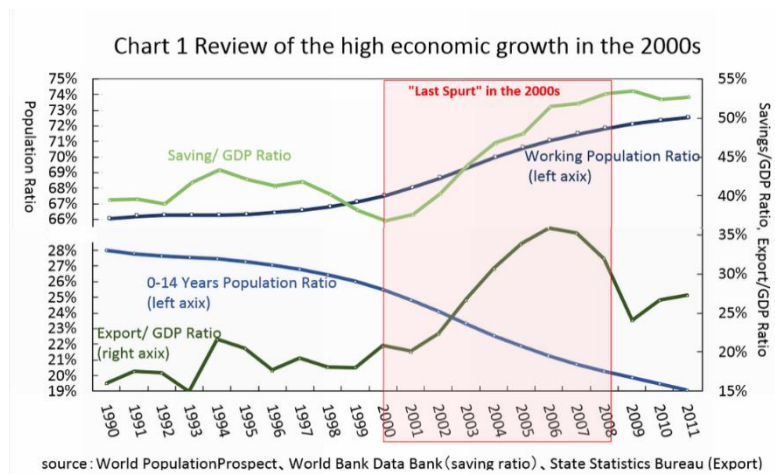
Introduction

The Chinese economy has grown significantly in the last 30 years. It is widely expected that this rapid development will continue for at least the next 10 years and that the country's GDP will surpass that of the US by 2030. However, the results of this study suggest that China's economy moved into middle development mode at a growth rate of about 5% several years ago. This report also proposes that the country's economic expansion will slow due to various factors, and that its GDP will not exceed that of the US. The following analysis of China's economic challenges is made from the viewpoints of problems in the short term (over the next few years), the medium term (before 2020) and the long term (after 2020).

(1) Shift of the Chinese economy into middle development mode

[1] Review of high economic growth in the 2000s

The analysis starts with a review of China's economic growth in the 2000s (Chart 1). GDP growth can be discussed from two viewpoints: i) that of the Troika Model, in which consumption investment and export are observed, and ii) that of Growth Theory, in which economic growth is attributed to labor input, capital input and total factor productivity (TFP).



a) Sudden surge in exports

After joining the World Trade Organization (WTO) in 2001, China achieved great success through its world factory strategy and associated lower costs (as shown by the rise in its export/GDP ratio). Along with export volume growth, the movement of 200 million people from rural areas to coastal cities for reasons of employment led to a massive labor input, thereby activating the surplus rural workforce. Productivity also improved as a result of this labor transfer from agriculture to manufacturing, thereby creating higher added value. The increased earnings of these workers further boosted incomes in agricultural areas as a result of remittances, which led to increased spending nationwide.

b) Sudden surge in savings

Rising earnings resulted from an increase in the number of breadwinners (i.e., a higher working population ratio), and the income growth described in a) above led to the accumulation of savings (see the rise in the savings/GDP ratio in the above graph). Another factor leading to increased savings was a decline in the child population ratio,

which alleviated the burden of childcare expenses on families. This sudden surge of savings facilitated investment-led development after the late 2000s.

c) TFP improvement

The labor transfer of 200 million people not only enhanced the productivity of the entire economy; the country's infrastructure also developed rapidly with a high return on investment. In addition to these factors, TFP was significantly improved due to the introduction of foreign technologies and management methods, heightened competition from an open economy and accession to the WTO, the spread of Chinese-style labor management with the setting of standards to be reached, the increased popularity of higher education, and the advancement of financial markets.

[2] Turning point in 2007

Around 2007, this business model reached a turning point due to the three factors outlined below.

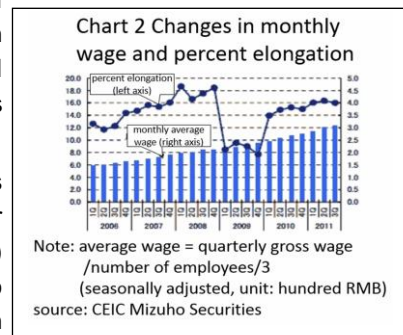
a) Exports no longer leading economic growth

Chart 1 shows that China's export/GDP ratio peaked in 2006 before the Lehman Shock. At that time, the country also decided to abolish favorable treatment for foreign companies under the guise of ending discrimination against Chinese companies. However, the actual reasons were i) the coastal export industry had expanded too much for the world market to support its rapid advancement, and ii) China was losing its edge as a world factory, with manpower running short and labor and other costs soaring.

Box 1: Wage surge and the Lewisian turning point

Increased labor costs caused a marked wage surge in the mid-2000s (Chart 2). This surge started in southern China before spreading over the entire coastal area and to the inland area, and on to rural areas today. At this time, China entered a period of labor shortage.

Although discussions continue as to whether China's redundant labor force has now been exhausted, worker immigration from inland areas (in the agricultural sector) to coastal areas (in the industrial sector) with no corresponding wage increase is no longer possible. It can therefore be concluded that China has passed the Lewisian turning point.



b) Need for increased industrial productivity and added value

A sharp upswing in labor costs causes price escalation due to the productivity gap that forms among industries. For economic expansion to continue, industrial productivity and added value must rise faster than wages and prices. Otherwise, the economy will find itself in a blistering growth situation characterized by nominal but not actual growth (the middle-income trap phenomenon is also based on a similar situation).

c) Diminishing effects of TFP improvement

Continued population transfer from rural to urban areas may contribute to productivity enhancement in China's economy. However, the labor shortage observed in coastal cities indicates that this effect has become smaller than that seen during the world factory period of the early 2000s. Moreover, although TFP is expected to continuously improve as a result of infrastructure development, diminishing marginal utility is

expected due to the introduction of foreign technologies and management methods, the spread of labor management and higher education, and the advancement of financial markets.

Based on analysis of these three considerations, it can be argued that China's economy peaked in around 2007, when its real GDP growth rate exceeded 13%, and shifted into middle growth mode at an annual rate of about 5%. Although China has seemingly continued developing rapidly at a rate of around 10% since then, this is because the growth rate has been unnaturally inflated by the 4-trillion-yuan investment program discussed below.

(2) Short-term problems: aftereffects of the 4-trillion-yuan investment program

After the Lehman Shock, China introduced an investment-centered development policy symbolized by its 4-trillion-yuan investment program. However, the policy has caused such serious aftereffects that it can no longer continue. Several factors are outlined below to explain why it has become difficult for China to make use of fixed-asset investment for economic expansion.

[1] Significant overinvestment

According to data released by the National Bureau of Statistics in January 2013, the amount of completed investment in fixed assets (which differs from fixed-capital formation as defined by the Systems of National Accounts) in 2012 was 36 trillion RMB (approx. 576 trillion JPY or 5.8 trillion USD; Chart 3 provides a detailed breakdown).

The 4-trillion-yuan program was centered on public investment in commercial infrastructure to avoid overinvestment. In order to put this plan into practice, however, China expanded its money supply on an unprecedented scale. As a result, the money supply (M2) and the amount of loans from financial institutions had doubled within four years, and the M2/GDP ratio also climbed to 1.9 (Chart 4). This oversupply of money caused investment to swell from 4 trillion to 10 trillion RMB, resulting in overinvestment that ate up future demand in advance across all industries from manufacturing to real estate.

In the manufacturing industry, which accounts for a third of all current investment, product prices have plummeted due to overinvestment (Chart 5). In the real estate business, which accounts for a quarter of current investment, no further boom can be expected for the time being. Fearing that the soaring property prices seen in recent years could threaten people's confidence in Communist Party rule, the State Council has eagerly restrained speculation. In the field of public investment mainly

Chart 3 composition of 36 trillion RMB fixed investment (Y2012)

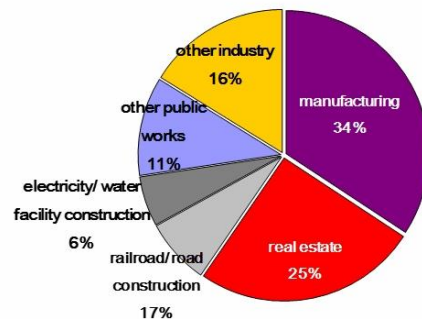


Chart 4 monetary expansion after "4trillion package"

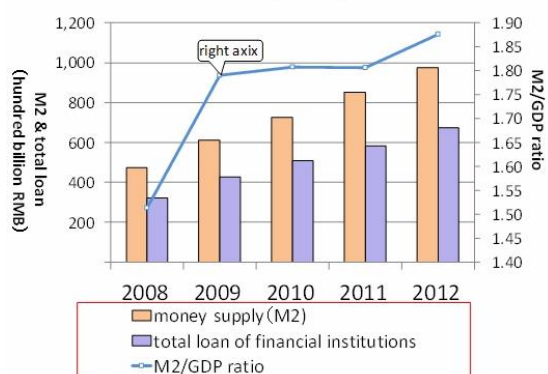
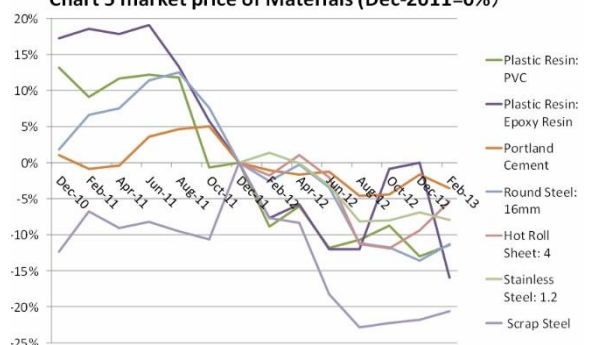


Chart 5 market price of Materials (Dec-2011=0%)

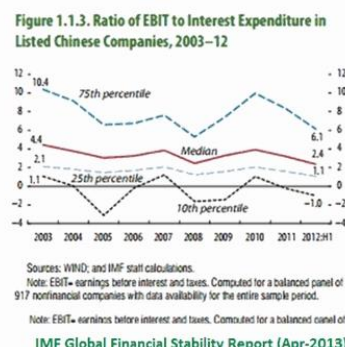
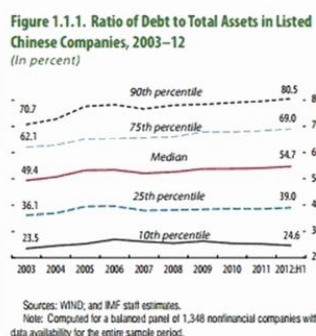
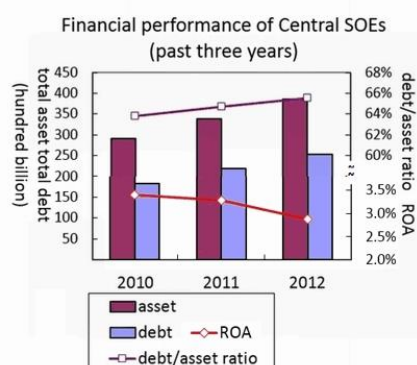


made by local governments, which accounts for another quarter of all investment, municipalities have run up huge debts.

[2] Corporate finances indicating the limit of investment-centered development

Overinvestment relying on interest-bearing liabilities is undermining corporate finances. According to compiled data released by the state-owned Assets Supervision and Administration Commission on around 800 state-owned enterprises directly under the control of Central Government, the debt ratio rose to 65.6% in 2012 from 63.8% in 2010, while the return on assets (ROA) ratio dropped to 2.9% from 3.4% (Chart 6).

Chart 6 Financial performance of Central SOEs (past three years)



The total amount of liabilities in 2012 was 25.3 trillion RMB, and the volume of net profits was 1.1 trillion RMB. Supposing that debt costs are represented by interest rates, a 1% interest increase will cause the income of state-owned enterprises directly under Central Government to decline by 25%. Further accumulated liabilities and higher interest rates are also expected to reduce the meager earnings of state-owned companies even more.

Based on more detailed analysis of listed Chinese firms for which data are available, the Global Financial Stability Report published by the International Monetary Fund (IMF) in April 2013 pointed out that corporate profits have failed to keep pace with the rise in interest burdens. This is evidenced by the fact that the average debt/equity ratio in the top decile of companies has reached 80%. The report also adds evidence that the median of the ratio of earnings before interest and taxes (EBIT) to interest expenditure among 900 listed firms fell from 4.4 in 2003 to 2.1 in the first half of 2012.

Continued low-yield investment by state-owned companies relying on interest-bearing debts is expected to result in an increase in the number of delinquent loans among monetary institutions and to place a heavy burden on central finances in the future.

Rapid expansion of shadow banking indicating money flow deterioration

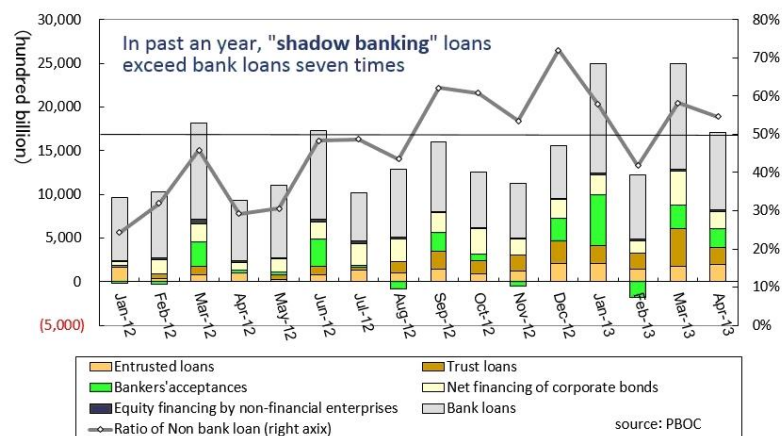
Since 2012, the incidence of financing with high interest rates (known as shadow banking) in China has expanded while bank financing growth has slowed (Box 2).

Box 2: Shadow banking in China

The shadow banking that takes place in China was invented as a high-yield wealth product for cash-rich bank customers who are reluctant to deposit money in bank accounts with regulated low interest rates. Such lending usually takes the form of entrusted loans or trust loans mediated by banks. The number of corporate bond issuances by listed companies is also increasing rapidly. Interest on entrusted loans and trust loans is more than 10% for short-term lending over a period of one to two years, which is 1.5 times higher than the interest on an ordinary bank loan.

According to PBOC's Aggregate Financing of the Economy statistics (Chart 7), the YoY increase in bank loans at the end of the first quarter of 2013 was 3.2 trillion RMB, while the figure for shadow banking was 2.8 trillion RMB. Although bank loans are still prominent in terms of the absolute amount, the YoY growth rate was 23% for bank loans and 130% for shadow banking. In total, aggregate financing in the first quarter of 2013 amounted to 6 trillion RMB – a 58% increase on the 3.9 trillion RMB figure for the previous year.

Chart7 Changes in the Aggregate Financing of the Economy (flow)



With a money supply (M2) as large as 1.9 times GDP, China has one of the most ample money supplies of any major country. Nevertheless, it has experienced a phenomenon similar to a credit crunch in which firms exhibit high demand for loans despite high interest rates.

One of the reasons behind this is large-scale investment in fixed assets over the past few years. The majority of such investment was funded by interest-bearing debts. Although the terms of redemption (three to five years) are now ending, these investment projects have not earned sufficient returns. As a result, banks are now very cautious about lending, in contrast to their approach of financing without limitation in 2009.

Refinancing bank loans via shadow banking does not represent the return of principal amounts to the financial sector. Despite being well supplied, China's money flow is deteriorating because significant funding remains frozen in low-yield investment projects. As a result, the pool of funds available for new projects is shrinking and interest rates are climbing.

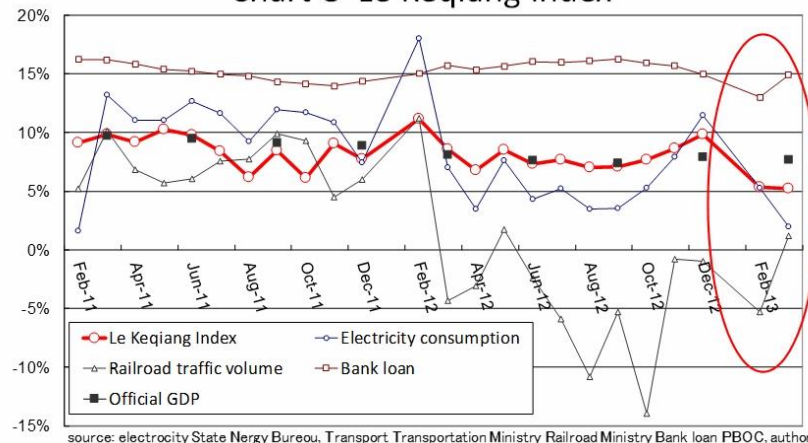
This heavy reliance on investment and deteriorating fund flow indicate that the policy of growth rate maintenance based on investment has been pushed to the limit. Believing that there is still considerable demand for infrastructure development in central and western regions and in the course of urbanization, some scholars encourage the government to continue on this path of growth centering on investment. However, it is clear that investment must slow down.

[3] Reasons for the recent stall in economic growth

The National Bureau of Statistics announced in April 2013 that China's real GDP growth rate in the first quarter of the year had been 7.7%. Meanwhile, the year-on-year rate of power consumption growth fell to 4.1%, which was as low as the level seen in the third quarter of 2012 when an economic slowdown was reported (the monthly rate in March was 1.9%). The railway freight volume growth rate improved to -1.3% from -5.3%, while the ratio of truck freight volume fell to 12.3% from 20.2%. The Chinese business cycle experienced an abrupt slowdown in summer 2012 and reportedly bottomed out in autumn of the same year. However, the downward trend has been escalating again since the beginning of 2013.

Chart 8 shows the author's calculations based on a non-official estimation metric called the Li Keqiang Index. This index was named after the incumbent Premier Li Keqiang, who pledged to focus on statistics relating to power consumption, freight transportation and banking rather than relying on official GDP statistics.

Chart 8 Le Keqiang Index



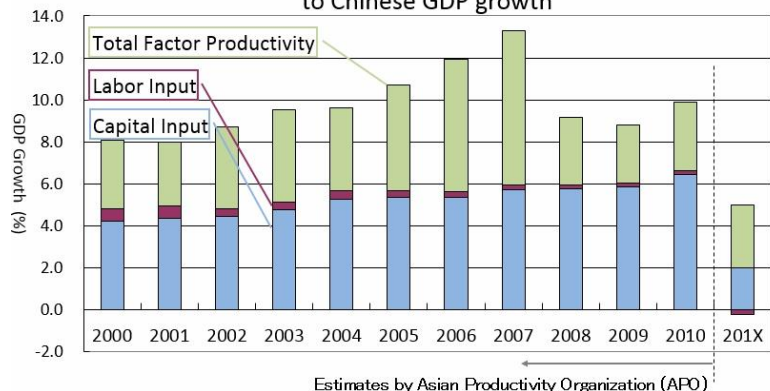
The amount of investment in fixed assets in the first quarter of 2013 was reportedly 4.8 trillion RMB (a 20% year-on-year rise). However, if this volume of investment had actually been made, the business cycle would not have tailed off. Some people, both inside and outside China, doubt the accuracy of the GDP growth rate (7.7% in the latest first quarter) because fixed capital formation is said to have accounted for half of the growth rate.

[4] Feasibility of investment restraint

As described above, uncontrolled investment in recent years has impaired the state of corporate finances, especially in the state-owned sector, and adversely affected fund flow throughout the entire Chinese economy. If investment does not slow down, the financial sector is likely to be burdened by a tremendous number of non-performing loans in the near future.

Restraining investment to an appropriate level is essential for the future of the Chinese economy, especially in ensuring the long-term soundness of central finances. Meanwhile, as investment accounted for half of an 8% increase in GDP, curbing it to the same level as the previous year is expected to slow GDP growth (Chart 10). The growth rate over the next few years may not reach even 5%.

Chart 10 Contribution of three production factors to Chinese GDP growth



China's new leaders promised to double national and personal incomes by 2020 at the 18th Party Congress last November. Going back on this pledge within less than a year would cause them to lose face, which could even affect the foundation of their political leadership. They are caught on the horns of a dilemma.

At a State Council Meeting on May 13, Premier Li Keqiang stated, "Even if we wanted to use public direct investment and other economic stimuli to achieve this year's development targets, there remains very little room to do so." He seems to have reached a firm conclusion that there is no choice but to slow investment. However, it is politically difficult for him to accept a situation in which investment is curbed so drastically that a free-fall recession results.

Thus, the leadership will have no alternative but to gradually slow investment over a period of years. However, this will cause the economy to remain bearish until the late 2010s. Moreover, the longer the process takes, the more inefficient investment will cause an accumulation of non-performing debts. As a result, a heavier burden will be placed on future finances.

Far more seriously, the Chinese government may have padded official GDP statistics even though investment has already slowed down. Data manipulation may widen actual fiscal deficits because GDP growth rates are used in national finance considerations such as budgeting revenues and expenditures. If the gap between reality and statistics opens up, the market will eventually see through this, which may cause turbulence in the exchange market.

(3) Medium-term problems: downsizing state capitalism

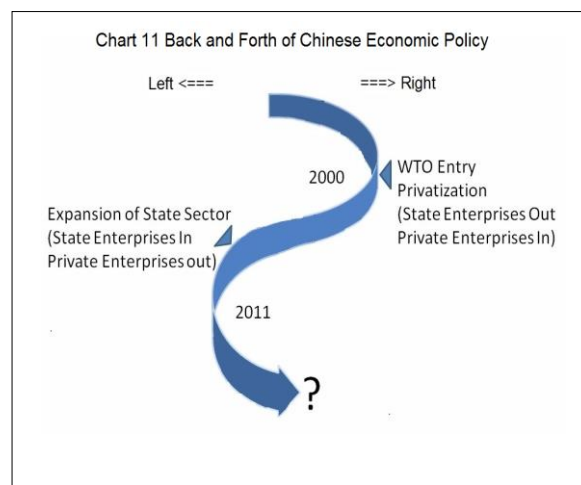
As described in (1) above, the Chinese economy faces the medium-term challenge of boosting productivity and added value more rapidly than the rise in wages and prices. However, with the current economic system in which the state-owned economy plays a major role, it is difficult to succeed in this task. To maintain growth, two major areas need to be addressed as outlined below.

The country's short-term problems involve the aftereffects of past investment, and of course it is impossible to go back in time to solve them. However, the question of whether its medium-term problems can be solved depends on policy options in the future. The key to success is whether the Communist Party and the government can overcome the enormous vested interests that exist.

[1] The huge cost of state capitalism

Over the past few years, Chinese economic policies have swung back and forth in terms of maintenance of the public-ownership economy and the promotion of privatization (Chart 11).

Facing a recession in the late 1990s, Jiang Zemin and Zhu Rongji (the leaders of the last-but-one administration) promoted economic reform by taking advantage of WTO participation. They shrank the public-ownership economy, which had become difficult to maintain due to financial problems, and accelerated economic privatization (pushing state enterprises out and bringing private enterprises in). Based on the Chinese classification, the pendulum swung to the right.



However, the situation changed again in the mid-2000s, when the health of national finances and state-owned firms' finances was restored as a result of dramatic economic expansion after China joined the WTO and as state-owned corporation reform progressed. The public-ownership economy was re-established (seen as a leftward policy shift). During the Hu Jintao and Wen Jiabao administration, there was a noticeable expansion of the state-owned sector (with state enterprises brought in and private enterprises pushed out). This trend became decisive when massive numbers of orders were placed with state-owned companies in 2009 under the 4-trillion-yuan investment program.

In 2009, there was a clear contrast between the post-Lehman economic recession observed in developed countries and the swift economic recovery seen in China. Many people praised the Chinese economy as the savior of the world economy. In China, government leaders and the

public gained confidence in their own economic management, singing the praises of state capitalism and Beijing consensus. This confidence dampened admiration for the Western market economy. However, the situation is now changing again as described below.

a) Excessive benefit for the government/state-owned sector from economic growth

The recent exacerbation of income distribution disparity in China has become a social issue, with the Xi Jinping and Li Keqiang administration promising to take remedial action. However, the disparity of distribution between the public and private sectors is even more serious than the gap between rich and poor.

China's government/state-owned sector have unique sources of income such as hidden land profits inflated by economic growth, though their tax rates are almost the same as those of other countries. Moreover, dividends from the state-owned enterprises that monopolize many essential industries are mostly reserved for their holding companies. Despite such state-ownership, hardly any of the profits from these enterprises go to the national treasury. In the banking sector, the interest margin is as high as 3% (annual margin: 3 trillion RMB). Because the public sector takes such a large portion of profits, neither businesses nor the household sector benefit significantly in terms of increased wealth.

b) Distortion of competition and facilitation of corruption as a result of enormous governmental administrative and economic power

Chinese people use the terms *inside/outside the framework* to distinguish enterprises, organizations and individuals under the umbrella of the government/state-owned sector from others. Because of the government's enormous administrative and economic power, those inside the framework are given preferential treatment over those outside it. This differentiation significantly distorts competition. Another factor impairing healthy economic development is the burdensome procedures involved in obtaining permits and licenses, which increase the cost and time investment needed by businesses forming or expanding. This powerful, multilayered situation of permit and license rights has produced a hotbed of corruption, causing the dominance and waywardness of the privileged few who have strong connections with senior officials in the Communist Party and the government.

c) Hampering of tertiary industry advancement, job opportunity development and other areas of progress due to industrial monopoly of enterprises directly under the Central Government

State-owned enterprises directly under the Central Government are dominant in key industries such as financing, communications and energy. Unlike state-owned firms under local governments, such enterprises tend to avoid competition and fall short in terms of investment and supply. As a result, the potential of these key industries is not fully realized. This is said to be one of the reasons why university graduates are often paid on a par with the low wages of blue-collar workers.

[2] Need for government/state-owned sector downsizing

For medium and long-term economic development in China, productivity and added value need to rise faster than the hike in wages and prices. However, it is difficult to achieve this target with a government-led economy. To succeed, it is necessary to correct the unbalanced distribution between the public and private sectors, ease regulations in order to reduce competition-distorting administrative power, and promote private-sector advancement by removing the dominance of the state-owned sector in key industries.

China may have a price to pay for its gross deviation from the principles of the market economy. The country's economic policy has swung too far toward a *state enterprise in, private enterprise out* policy, and must change course again toward a *state enterprise out, private enterprise in* situation. Otherwise, the nation could struggle to break out of the current trap in which it finds itself. The major obstacle is the government/state-owned sector and its massive vested interests; any efforts to downsize this sector are expected to be fraught with political difficulties.

[3] Need for change in the roles of public finance

Chinese local governments have consistently invested in infrastructure and industrial advancement in the name of economic development. Although infrastructure investment produced significant results before the early 2000s, their marginal utility has diminished recently. The industrial advancement policy has also caused serious overinvestment in steel, solar panels and other industries, and the participation of local governments in economic development exerts an increasingly harmful influence. The question of whether local public finance can exit these fields is another challenge to China's realization of medium- and long-term economic development.

Meanwhile, some roles of local public finance should be expanded. The farming population (which accounts for two-thirds of the total) is not provided with adequate public services such as those relating to education, health care, housing, unemployment insurance and pensions, which are connected to the family registration system.

The lack of social security for farmers has widened the disparity between rural and urban dwellers, and is the most significant influence behind China's wealth gap. The discontent of poor migrant workers unable to enjoy social-service parity in cities has risen to a level at which social stability is threatened. The equalization of public services by strengthening social security for rural registry holders is therefore essential for future economic development and social stability.

The problem has also significantly limited the consumption capacity of farmers in rural areas and peasant migrant workers in urban areas. Moreover, rural registry holders wishing to avoid housing shortages and disparity in cities are discouraged from employment-related urban migration. This has restrained population movement between rural and urban areas, causing obstacles to urbanization, worker shortages in cities and further rises in labor costs. Accordingly, solving this problem may also contribute to future economic development strategies.

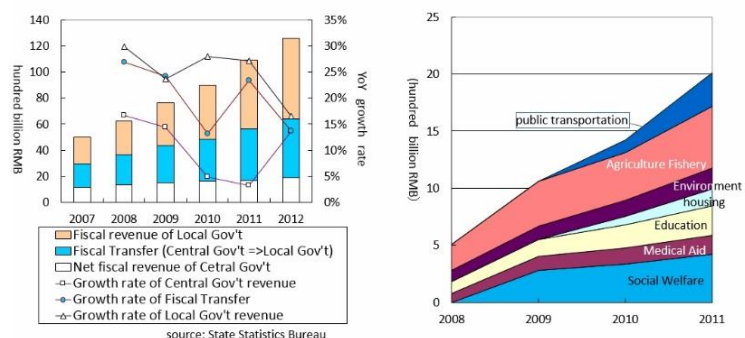
To summarize, the role of local finance must be shifted from one of economic development to one of public service/welfare expansion.

In this context, it can be argued that the promotion of fiscal transfer from central to local finance during the last five years of the Hu Jintao and Wen Jiabao administration for the purpose of public welfare was the right thing to do.

Large amounts of public funding have been allocated to rural areas and rural farmers

(Chart 12). It can be said that a reversal of roles in local public finance has already started.

Chart 12 Changes in Fiscal Transfer and its use



In contrast to the progress made with efforts for rural areas, measures to address the unequal treatment of peasant migrant workers in cities have hardly moved forward at all. Although the Xi Jinping and Li Keqiang administration has indicated a commitment to tackling this challenge in parallel with its urbanization policy, the policy has not yet taken concrete form.

Despite an acceleration in social security-related spending, no signs of spending cuts have been seen in the conventional policy focusing on economic development. The role of public finance has come to include everything, and public finances are expected to run out in the medium-long term if this situation remains unchanged.

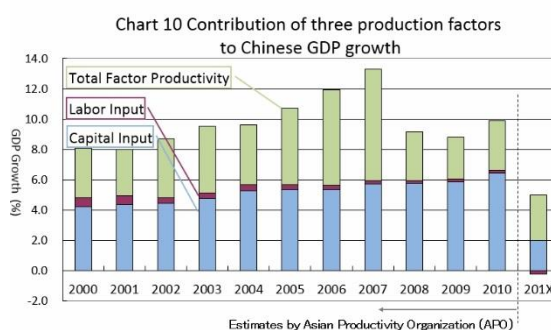
[4] Medium-term outlook for Chinese growth

As mentioned previously, there are two keys to the enhancement of productivity and added value in the medium term: i) economic revitalization based on the downsizing of government/state-owned firms and stimulation of advancement in the private sector (in short, a change of course to a *state enterprise out, private enterprise in* situation), and ii) a change in the role of public finance to promote public welfare. In both cases, the greatest challenge is to overcome political opposition from vested interests.

The new administration is preparing to accelerate urbanization as a leading policy to improve future productivity. In the 2000s, China succeeded in implementing labor transfer to engage the farming population in secondary and tertiary industry, which contributed to TFP improvement. Based on this experience, the administration is planning to raise the urban ratio to the global standard (70%) and move 200 million more people from rural to urban areas.

It is important to fully realize the potential of industries that offer good employment opportunities (particularly in the tertiary sector) to prevent the creation of slum areas from population transfer to cities. Moreover, without an accompanying increase in employment, new residential areas developed by the government may become ghost towns reflecting further overinvestment.

Chart 10 (Contribution of labor input, capital input, and TFP enhancement to China's GDP growth) in (1) is referred to here again. The height of the green columns representing the contribution of TFP enhancement will depend on the extent to which the medium-term targets of the Xi Jinping and Li Keqiang administration are achieved.



It remains to be seen whether these efforts will succeed or not. The 18th Party Congress Work Report (issued in November 2012 as a policy statement for the next five years) included no new content on state-owned enterprise reform even though this is the most significant problem in terms of vested rights. The new

administration has attempted to formulate policies for a real market economy; examples include deregulation, the entry of private companies into industries previously monopolized by state-owned companies, and structural tax reduction through a switch from business tax in tertiary industry to value-added tax. However, these steps were tried in vain by the Hu Jintao and Wen Jiabao administration. Attention should be paid to whether these policies will be modified at the Central Committee meeting of the Communist Party scheduled for autumn 2013.

(4) Long-term problems: the unavoidable issues of a declining birth rate and an aging population

Demographic problems remain long-term challenges for the Chinese economy. As a result of the long-running family planning policy, China has fallen into an irreparable state characterized by a sharply plunging birth rate. The working population is already shrinking, and the total population is expected to start dwindling in the early 2020s – a decade in which influences harmful to economic advancement may begin surfacing. Working input will then drop, and the decline of the total population will lead to lower demand. Eventually, these factors are expected to encumber economic growth.

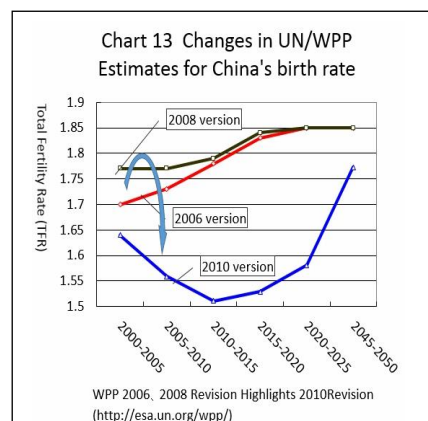
[1] Birth rate overestimation

China has implemented its family planning policy for the last 30 years. Under this approach, the government imposes strict control measures such as fines for couples having more children than allowed, forced abortions and contraceptive operations. Although the birth rate (i.e., the total fertility rate) has shown a clear decline since the 1990s, the policy has never been relaxed and only minor modifications have been made. This is partially due to the vested rights of the presiding ministry (the Population and Family Planning Committee), which seeks to preserve its regime. Another reason is that couples may attempt to hide children from census takers to avoid penalties, which hampers efforts to clarify the actual number of children born.

Another cause of inaccurate birth rate estimation is the fact that the World Population Prospect (WPP) has continuously provided population projections on the high side closer to those of the Population and Family Planning Committee. The WPP is issued by the United Nations Population Division, which started to support China's family planning policy at an early stage. It presents global population projections every other year, and is respected as a highly authoritative demographic prediction. As such, it is referred to by research institutions all over the world.

Box 3: The enigma of WPP estimates on China's birth rate

The WPP estimated China's total fertility rate (TFR) as 1.70 in 2006 and 1.77 in 2008 (Chart 13). Previous analysis in and outside China has extensively been based on this 2008 estimate, and related results have suggested that the country's total population will peak in 2032. However, it was long suspected that the estimate was too high, and in the 2010 WPP it was slashed to 1.58. Based on this figure, the peak will come in 2026 – six years earlier than previously estimated. The United Nations has not explained why the estimate was changed by such a large margin and so abruptly.



[2] Actual birth rates

The National Bureau of Statistics has expressed concern over the impact of the declining birth rate and aging population, and was particularly careful with its population census in 2010. The results, which were released more than a year after the survey, were a shock: the national average birth rate was only 1.18 children per couple, and the corresponding figure for Beijing and Shanghai was just 0.7 (Chart 14).

However, Chinese experts suspect that the actual birth rate may have been higher than 1.18 because of hidden children, and estimated an actual rate of about 1.4 (Cai Fang and others).

Chart 14 Total Fertility Ratio (TFR)s by provinces and areas
(Top 5 and Bottom5)

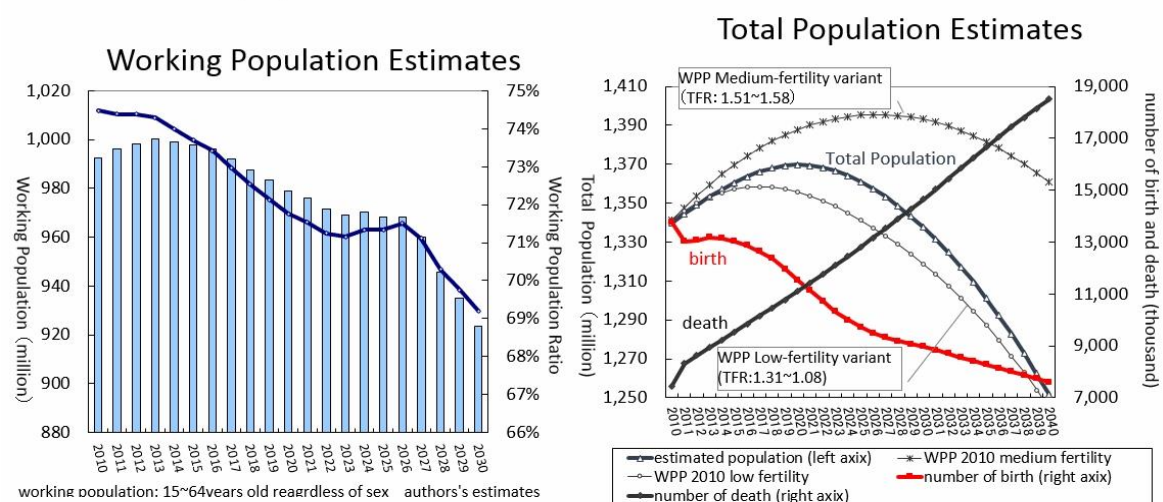
area	across the Province	urban area	town area	rural area
across the country	1.18	0.88	1.15	1.44
Beijing	0.71	0.70	0.68	0.72
Shanghai	0.74	0.71	0.81	0.81
Liaoning	0.74	0.61	0.70	0.96
Heilongjiang	0.75	0.67	0.70	0.85
Jilin	0.76	0.59	0.74	0.90
Anhui	1.48	1.00	1.34	1.78
Hainan	1.51	1.09	1.47	1.81
Xinjiang	1.53	1.04	1.28	1.81
Guizhou	1.75	1.20	1.56	2.03
Guangxi	1.79	1.15	1.66	2.15

2010 Population Census (State Statistics Bureau)

[3] Future population estimates: onset of population decline almost 10 years earlier than suggested by commonly accepted projections

Chart 15 shows the author's estimates based on a birth rate of 1.18. According to this calculation, the labor population between the age of 15 and 64 will start falling in 2011, and the total population will start falling in 2014. By way of comparison, the National Bureau of Statistics announced in January 2013 that the working population between the age of 15 and 59 (corresponding to the currently established retirement age) started dropping in 2013.

Chart 15 Estimates of Future working population and total population based on the 2010 Census



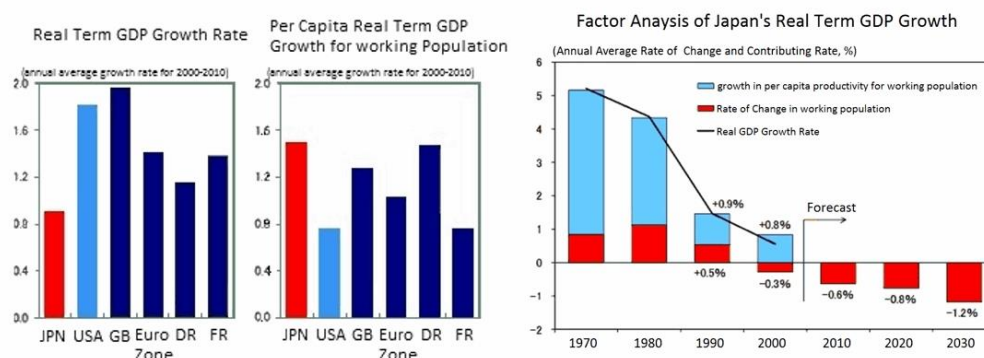
The calculation indicates that the total population will start to decline in 2021. Meanwhile, assuming that the birth rate is now 1.56 but will later recover, the 2010 WPP estimate indicates that the total population will start to decline in 2027. Supposing that the actual birth

rate is around 1.4 as suggested by Cai Fang and others, the total population will therefore start to decline in the early 2020s sometime between these two estimates. This is about 10 years prior to the 2033 estimate based on commonly accepted projections.

[4] Influence on economic development with Japan as a case study

Japan's experience provides pointers as to how China's declining birth rate and aging population may influence its economy. Chart 16 shows related Bank of Japan data highlighting economic effects according to Growth Theory (See (1) at the beginning of this report), which links economic expansion with labor input, capital input and TFP.

Chart 16 Negative Effect of Population Decrease
—Japan's Lesson



A simple comparison of the GDP growth rates observed in major developed countries over the last 10 years or so shows Japan in last place. In contrast, comparison of GDP growth rates per member of the working-age population puts Japan top. To summarize these contrasting results, it can be said that even if each member of the working-age population exhibits a high level of performance, there is necessarily a negative impact on development when the labor population shrinks.

In Japan, labor population shrinkage is expected to further accelerate due to the declining birth rate and aging population. According to Growth Theory, productivity enhancement great enough to more than offset the negative impact of a -1.2% decrease in the labor population will be needed for real economic expansion in the 2030s. An impact from reduced consumption due to the shrinking total population is also expected.

[5] Possible countermeasures

In China, people have only recently started discussing the concept of diminishing demographic bonus. But the harmful influence will not be limited to a reduction of positive effects, rather it will result in a shift into reverse gear against economic growth. In this context, an immediate change in China's policy is required. In particular, as second-generation baby boomers born in the late 1980s have reached childbearing age (until around 2025), restoring the birth rate during this period would be highly effective.

However, it would be challenging to deregulate or abolish existing control measures due to the fixed mindset and powerful vested rights of the family planning sector. In particular, if the government admits that continuing its family planning policy would be a mistake, rural residents previously subjected to harsh fines may strongly appeal for refunds.

Against such a background, even abolitionists (such as Cai Fang and others) propose a roadmap by which the family planning policy would be gradually deregulated for the time being and completely abolished in 2020, followed by a shift to an encouragement of childbirth in

around 2026. However, this schedule seems too slow because the female population of childbearing age will have declined by then.

The recent birth rate decline is also largely attributed to surging childcare expenses and a change in the way young people view life. It is unlikely that deregulation alone will cause the birth rate to recover. To this end, measures to encourage and support childbirth need to include drastic aid for a wide range of issues to address high educational and housing costs. In this regard, the fiscal burden related to public welfare is expected to increase further.

(5) Directionality of waning growth

[1] Summary of previous chapters

China's rapid economic expansion is commonly expected to continue for at least the next 10 years, with its GDP surpassing that of the US by 2030. In contrast, this report argues that such scenarios are threatened by the challenges outlined so far, which are summarized below.

- a) In the short term, China needs to slow its current large-scale investment. However, regardless of the rate of such slowing, the growth rate is unlikely to reach 5% for the next few years.
- b) In the medium term, China needs to downsize its public sector and revitalize its economy, but these tasks are extremely difficult in political terms. Without effective outcomes, TFP is expected to stall rather than being a driving force for future development. Consequently, the potential growth rate is expected to plummet by 2020.
- c) In the long term, China cannot avoid the effects of its declining birth rate and aging population, which will impede economic expansion. The actual impact is expected to appear after 2020. In the late 2020s, when both the total and labor populations start to decline in full swing, continued economic growth is expected to be difficult.

It is rash to conclude that a stalled economy would directly lead to social disorder, although the Chinese government itself has been obsessed by such a threat for years. In reality, while the 4-trillion-yuan investment program underpinned economic growth, Chinese society fell into a rather tense, unstable situation. Meanwhile, based on its considerable efforts for rural development, the Hu Jintao and Wen Jiabao administration is often highly evaluated as a good government in rural areas despite being criticized for creating a decade of neglect and retrogression in urban areas.

Today in China, societal tensions are mounting as people's awareness of their rights and sensitivity to corruption and environmental pollution grow. However, if distribution reforms are successful, society will not be necessarily destabilized even if economic growth wanes.

[2] Potential risks

When development slows down, the Chinese economy will face a variety of risks as listed in Chart 17. On the other hand, the Central Government, for better or worse, has greater economic power than other nations' governments. In this regard, there is a significant possibility that any immediate problems will be resolvable via fiscal stimuli and other measures.

Chart 17 Potential risks to China's economy

Risk	Possible situation
Increased unemployment	Unemployment and difficulties in returning home for farmer migrant workers engaged in the construction industry; a job shortage for university graduates; increased unemployment due to closure and bankruptcy of private export companies
Inflation	Public protest against hikes in energy and utility charges and a shortage of daily necessities caused by panic buying (though inflation already considerably

	exceeds the official CPI level)
Real estate issues	Price collapse due to competition between low-end private housing and public housing (i.e., the bubble bursting); widespread public protest against the introduction of the property tax currently under consideration
Financial crisis	Loan defaults for extortionate lenders and shadow-banking moneymaking products; financial market disruption

[3] Financial failure: the most significant risk

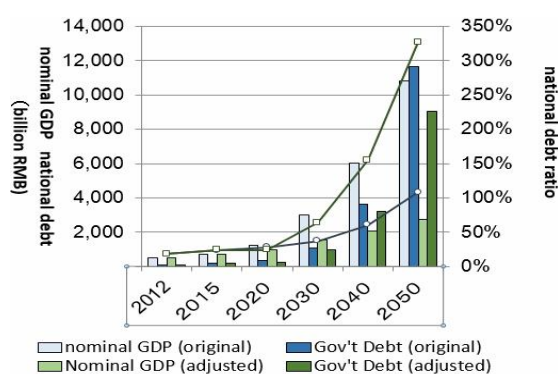
Economists and analysts have recently published provisional calculations related to the national long-term debt focusing on the issues of local government debt, increasing pension liabilities due to the aging population, and environmental destruction. One calculation in particular warns of the pension liability issue, indicating that without pension reform (e.g., an upward revision of the pensionable age), national pension liabilities will reach 80% of GDP and the total national debt will reach 107% of GDP as of 2050.

This research is quite valuable in that it sounds an alarm regarding the pension debt issue by highlighting hidden liabilities that Chinese people were previously hardly aware of. However, the research assumptions that the GDP growth rate will be 7.2% in 2025 and 5.2% in 2030 on a real basis are very optimistic, and such provisions materially affect long-term estimation of national liabilities. How will the results change if growth rates plunge as this report predicts?

Chart 18 shows the author's calculations based on the above-mentioned estimation to generally illustrate the effects of declining growth rates. In addition to the original assumption, this calculation involved setting the growth rate at 7.0% on a nominal basis and 5.0% on a real basis for 2015, 5.0% on a nominal basis and 3.0% on a real basis for 2020, and 3.0% on a nominal basis and 1.0% on a real basis after 2030 (a low-growth scenario).

Among the three types of hidden liabilities estimated in the original case, the costs of local government debt and environmental destruction are taken as-is because they are based on the assumption that related effects will appear in the short term. Pension debts are recalculated using the differences between nominal and real growth rates as an alternative deflator.

Chart 18 Long-term estimates of China's national debt
(with hidden debt taken into account)



unit: 100 bn RMB										
	2012年	2016年	2020年	2026年	2030年	2036年	2040年	2045年	2050年	
base estimates	Nominal GDP	529	736	1,230	1,910	2,988		6,001		10,838
	growth rate (real)	12.3% 7.9%	11.2% 7.9%	10.2% 7.2%	9.2% 6.2%	8.2% 5.2%	7.2% 4.2%	6.2% 3.2%	6.1% 3.1%	6.0% 3.0%
	Gov't Debt	97	130	217		590		1,475		3,320
	Debt Ratio	18.4%	17.6%	17.6%		19.8%		24.6%		30.6%
	Gov't Debt	97	171	346		1,102		3,630		11,669
Caijing scenario	Debt Ratio	18.4%	23.4%	28.1%		36.9%		60.5%		107.7%
	local Debt and rail road	0	24	16						
	pension fund deficit	0	-6	6		403		1,800		6,014
	environmental costs	0	23	81						
	Debt Ratio	18.4%	24.3%	24.2%		0.0%		63.6%		154.9%
adjusted scenario (low growth rates)	Nominal GDP	529	704	987	1,259	1,532	1,776	2,059	2,387	2,767
	growth rate (real)	10.0% 7.7%	7.0% 5.0%	5.0% 3.0%	4% 2.0%	3.0% 1.0%	3.0% 1.0%	3.0% 1.0%	3.0% 1.0%	3.0% 1.0%
	Gov't Debt	97	171	239		974		3,189		9,048
	Debt Ratio	18.4%	24.3%	24.2%		0.0%		154.9%		327.0%
	local Debt and rail road	0	24	16						
adjusted scenario (low growth rates)	pension fund deficit	0	-6	6		384		1,714		5,728
	environmental costs	0	23							
	Debt Ratio	18.4%	24.3%	24.2%		0.0%		154.9%		327.0%

note: base estimates and original scenario was published in "Caijing" magazine June 2012)

[Caijing hypothesis]

1. Among Local Gov't debt (estimated as 10.2 billion RMB and due in 2016 mostly) and rail road Dep't debt (as 2.25 billion RMB), 30% of each will be non performed and borne by Central Gov't—800trillion RMB/y, but will not incur again.
2. without any reform, annual pension fund deficit will be 0.2% of GDP in 2020, 1.4% in 2030, 3.1% in 2040, and 5.5% in 2050 respectively. Cumulated deficit by 2050 discounted by nominal GDP growth rate would amount to 75% of nominal GDP
3. Environmental cost is estimated according to Green GDP estimate by Environmental Dep't that is based on the cost of emitted contaminants disposal by way of current technology

[Author's adjusted hypothesis]

1. Under adjusted scenario, growth rates are given by author as is shown in the Table.
2. Among hidden debt estimates, only pension fund deficit is recalculated based on adjusted growth rate and quasi deflator (nominal growth rate - real growth rate).

As a result, while the original research indicates that the total national debt will reach 107% of GDP by 2050, the national debt ratio will reach 300% in the same year in the low-growth scenario. However, this view may also be too optimistic in consideration of the following factors:

- a) In the original case, it is assumed that no non-performing debts will be derived from local government investment in the future. However, it is highly possible that such debts will continue to accumulate because it is not possible to put a sudden brake on investment in China.
- b) In the original case, it is also assumed that there will be no additional environmental destruction. However, as indicated by the PM2.5 problem, new forms of environmental disruption can be envisaged.
- c) Although GDP statistics may be manipulated, revenue and expenditure budgets are based on these statistics. There is a consequent risk that revenue will not be collected or there will be a virtual tax hike that may adversely affect the economy.
- d) China's pension fund pool is sparse, and no financial preparations have been made for measures to combat discrimination against migrant farm workers in cities or the declining birth rate and aging population. In combination, these issues are expected to create a greater fiscal burden on the public welfare system.

China's situation of central finance is today quite affluent. Based on this strength, the government will try to solve the various problems it faces. However, there is a risk of central finance running out. As such, financial failure is considered to be the most significant unavoidable risk caused by economic decline.

2. Suggestions for international relations and security in East Asia

(1) Changes in Chinese attitudes toward international affairs: from hide and bide to core interests

This report argues that China's GDP is unlikely to ever exceed that of the US. Some see it as a futile exercise to compare the GDPs of the two countries due to the unreliability of Chinese statistics, and place more focus on the importance of enhancing the quality of development. Nevertheless, this study takes up the issue because the expectation that China will surpass the US in terms of GDP has a harmful geopolitical influence on China and its neighboring countries.

[1] Hide-and-bide strategy

China was the world's largest empire until the 19th century. However, after letting down its guard against other countries and splitting internally, it suffered from foreign invasions for more than 150 years. This period of the nation's history produced three serious aftereffects in the mindset of later Chinese generations:

- a) A negative image of China as a weak, incompetent, lagging country
- b) Nationalism based on feelings of victimization
- c) A stronger hatred against compatriots who helped invaders (Chinese traitors) than against the invaders themselves

As part of the introduction of open economic reform, Deng Xiaoping set forth the Tao Guang Yang Hui (hide our capacity and bide our time) strategy. This was a low-profile policy based on the vision that there will be long, difficult times ahead before China becomes a great power again, so the nation should refrain from words and deeds that sound threatening to surrounding countries until it becomes strong enough. The approach was also referred to as the peace and development policy in the 2000s.

This policy was apparently aimed at returning a sense of China as a great power to its people, who view the nation as a lagging country based on their sense of inferiority. At the same time, the approach is also seemingly intended to control nationalism in order to prevent friction with other countries in the course of revival. This was previously an unwritten rule and a general consensus in Chinese foreign policy.

[2] Rise of the core interest policy

The Lehman Shock of 2008 was a turning point. In stark contrast to Western economies, which were deeply mired in recession, China's economy achieved a dramatic recovery in 2009 with the government's 4-trillion-yuan investment program, and was seen by some as the savior of the world economy. China's international status was also boosted, as symbolized by its hosting of the G20 meeting. Consequently, Chinese people's outlook on international affairs has changed drastically as follows:

- a) With confidence soaring, negative identity has receded to some extent, and the sense of the nation as a great power has escalated. At the same time, fading negative identity has enhanced self-assertion, and has diminished admiration of Western countries/values and the desire to assimilate them.
- b) Growing national strength and international status have resulted in a build-up of assertive nationalism. This has led to the development of a core interest policy (by which China will no longer yield core interests such as territorial land and waters) in stark contrast to the previous hide-and-bide strategy. Behind this lies a feeling of victimization resulting from China's loss of a variety of national interests over the last 150 years. This

conventional resentment has grown into a strong desire for these lost interests to be restored someday as Chinese people become more aware of their growing economic strength and rising international status.

- c) The social atmosphere by which Chinese traitors are condemned for betraying their country remains (there is a taboo against Chinese traitors). With broadening international knowledge and experience, Chinese attitudes toward international affairs have diversified under the surface. However, when it comes to core interests and historical recognition, a fear of condemnation makes people go along with social norms. It is therefore difficult for people outside China to recognize this diversification.

The core interest policy is thought to have started with an important address made by former President Hu Jintao at an internal meeting in July 2009. He is said to have altered the late Deng Xiaoping's instruction for China to hide its capacity and bide its time while achieving something in the process into **continuously** hiding its capacity and biding its time while **aggressively** achieving something in the process. It is also said that his original intention was to take positive action when necessary while continuing to keep a low profile so that China could maintain its balance of policies. However, the hardline tendency toward aggressively achieving something began to manifest itself more and more on various occasions, such as at the 15th Conference of the Parties (COP15) at the end of 2009 and during the South China Sea dispute. This policy eventually grew from a minor opinion to the official stance of the Chinese Government when Premier Wen Jiabao voiced it in his speech at the United Nations General Assembly in October 2010. This process apparently reflects a significant change in the attitudes of Chinese people as a whole toward international affairs, as mentioned above.

[3] New factor: public opinion

The shift from the hide-and-bide strategy to the core interests approach occurred not only inside the Communist Party and among foreign affairs authorities but also in the outlook of Chinese people as a whole. As a result, it has become more important to consider public opinion as a new factor when assessing the direction of future Chinese foreign policy. The Ministry of Foreign Affairs has clearly come to value (or go along with) public opinion at press conferences, although it is unknown whether such opinion accurately reflects people's views or is manipulated and modified by the authorities or influential groups.

The situation appears viable as long as this public opinion remains peace-loving and keeps in step with international society. However, the growing influence of the New Leftists gives rise to concern in this regard. Having missed out on their fair share of the recent economic prosperity, this group increasingly has complaints against society and assumes a critical view of the government.

Left: conservatives	Right: reformists
Rejection of reform and openness (market-oriented economic reform)	Support for reform and openness (market-oriented economic reform)
Opposition to Western values (freedom and human rights)	Acceptance of Western values
Extreme patriotism (nationalism)	Cooperation with international society

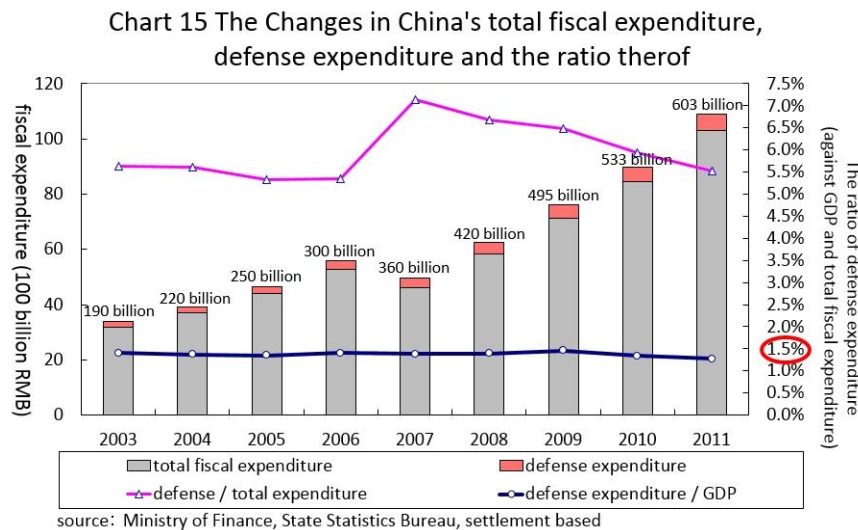
(2) Changes in China's neighboring countries

[1] Negative reactions by neighboring countries

China's hardline stance of refusing to compromise over core interests such as sovereignty and territorial land and waters has caused negative reactions from surrounding countries and the

US, which has a significant stake in the region. Concerns are growing because China has not only adopted an aggressive attitude regarding foreign policy but has also rapidly boosted its national defense expenditure.

China's national defense budget has consistently remained (officially) at 1.5% of its GDP (Chart 19). As long as this ratio remains unchanged, Chinese people barely notice the country's military expansion because the allocation of domestic resources remains the same as before. However, neighboring countries view the situation differently. For a nation with the world's second-largest GDP and double-digit growth, increasing defense expenditure at 1.5% of GDP is drastic. In response, countries in the Asia and Oceania region have started building up their own armaments.



Even if China's GDP statistics are padded, its defense budget will keep soaring drastically as long as the country maintains its period of high growth. This is one reason why attention should be paid to the nation's unreliable GDP statistics.

[2] Comments on the Senkaku Islands dispute

The Senkaku Islands dispute of September 2012 provided an interesting case study highlighting international relationships and the national stances of Japan/the US and China.

a) Reactions of Japan

China has stepped up public-vessel activity near the Senkaku Islands in recent years, causing Japan deep concern regarding the security of its territorial land and waters. In April 2012 in Washington in the US, former Tokyo Governor Shintaro Ishihara disclosed a plan for the city of Tokyo to buy the Senkaku Islands from their owner.

Although his political intent was unknown, it seems Japanese rightists and anti-Chinese groups shared concern that China's economic and military expansion would never stop, and that the longer it continued, the worse things would be for Japan.

In short, the prediction that China's GDP would surpass that of the US in the near future was behind the decision to buy the islands.

b) Reactions of China

Judging from China's reaction, Japan-US security arrangements have had a positive deterrent effect. Some Japanese people have reservations regarding US Army support in the event of an armed conflict between Japan and China. However, China is likely to remain reluctant to use armed force in the Senkaku Islands dispute as long as the threat of US Army support for Japan is real.

Based on the apparent limitations of its power, China must come to terms with public opinion agitated by nationalism. To achieve this, it appears to be trying to cool such agitation by asserting the approach of developing its capacities and waiting until the US has to give up its intervention in the Senkaku Islands issue. In this way, although the application of the hide-and-bide strategy has receded in recent years, it remains front and center in terms of China's relations with the US.

At present, most Chinese people think the country's GDP will surpass that of the US in the next 10 years. Further, the general view is that simply overtaking the US in this regard is insufficient; China must continue its expansion and far surpass America in terms of GDP. People also believe that holding more US bonds and the like will provide leverage over the US, giving China a strong position to negotiate for America to yield certain interests in East Asia.

c) Need for an awakening from the illusion of possibly surpassing US GDP

Box 4: China Net (Japanese version) 8/2/2012

In China, many people currently hold strong feelings of frustration against Japan. However, most of them overlook the presence of America behind the scenes and its strategic objective of playing both ends against the middle.

Against this background, China needs to get America to approve the core interest of lost territory and convince it that China will not oppose American interests in the Asia-Pacific region. The problem is that **this will take time**.

The US economy has yet to recover from the massive damage caused by the Lehman Shock. However, it holds at least three advantages:

- i) It can make rapid structural adjustments in areas such as labor and capital reallocation thanks to its market economy-centered system.
- ii) It is the only developed country to remain unaffected by the issues of a declining birth rate and an aging population.
- iii) It is a key-currency country.

The issue of overconsumption was previously seen as the biggest problem with the US economy. However, the situation has changed. According to OECD statistics, the US household saving rate in 2012 was 3.7%, already exceeding that of Japan (1.9%). A major task ahead for the US is to restructure national finance (e.g., national defense expenditure, tax reductions and Medicaid). President Obama has taken measures to rebuild the nation's finances despite fears of a financial cliff. Moreover, signs that the housing market (a major factor in the economic downturn) is bottoming out have now appeared on the horizon. The shale gas revolution has also cut the volume of current account deficits and partially revived the manufacturing industry.

China's exchange rate-converted GDP is currently half that of the US (or three quarters based on PPP conversion). In recent years, optimists in and outside China have predicted that the country will continue to grow at more than 7% annually on a real basis, and that the renminbi exchange rate against the US dollar will also rise at about 5% a year. Based on this view, such commentators expect China to overtake the US in terms of GDP in 2017 or later. However, such a prospect sounds absurd in light of the issues analyzed in this report.

Even if China's economy continues to grow at 5% annually until 2020, that of the US will also grow at 2% simultaneously, effectively resulting in a difference of only 3%. Accordingly, China's GDP will have reached only two thirds that of the US by 2020. Its population problems will also become a serious burden.

China dreams of surpassing the US in terms of GDP, narrowing the national power gap in other fields and standing on an equal footing with America. However, this dream is unlikely to ever come true.

In addition to a deceleration of economic expansion in the near future, China has not prepared for its declining birth rate, its aging population or the urbanization of its farming population. The nation has neither the time nor the money to address heightened tensions with neighboring countries and exhaust its economy through the non-compromising core interest policy, and will be heading in the wrong direction unless it awakes from its illusion immediately.

d) Similar state for Japan

Similar warnings can be applied to Japan, whose nightmare scenario of an endlessly growing China is just as unlikely as China's dream scenario of overtaking the US in terms of GDP. Japan and China share the same illusion from different angles.

A fear of deprivation and a feeling of being wronged have fostered anti-foreign and ultra-nationalist sentiments in Japan recently. Even historical revisionism, which seeks to completely deny the country's post-war systems, has also escalated. Even if these trends of thought are derived from the motive of protecting Japan, they are likely to guide the country toward isolation.

This report provides a detailed and comprehensive discussion of the possibilities ahead for the Chinese economy. Japanese people should not forget that their country has traveled a rugged road far ahead of China. Thanks to Abenomics, the Japanese economy is now on track toward recovery for the time being. However, without the success of Prime Minister Abe's "third arrow" development strategy, the effects of monetary relaxation and economic stimuli would soon disappear. Moreover, the Japanese administration has so far failed to devise any effective measures to address the declining birth rate and aging pollution. Like China, Japan has insufficient time and money to waste on disputes over territorial land and waters without solutions.

[3] Chains of negative reactions: diplomatic relations in East Asia

Due to China's rise, East Asia is in an unstable situation that would have caused armed conflict a century ago.

The optimistic expectation held by people in China and elsewhere that the country will continue its rapid economic growth and overtake the US in terms of GDP in the near future has aggravated this instability.

As well as being groundless, this expectation is also harmful to peace and development in the region. Against such a background, it is essential to dispel this illusion and face the harsh realities of the situation today.

