

NBR BRIEFING

POLICY REPORT

May 9, 2003, No. 13

What Does SARS Mean for China?

Neil J. Beck

The following short essay assesses the economic and political impact of SARS on China.

Introduction

Since November 2002, Severe Acute Respiratory Syndrome (SARS) has infected over 7,300 people in 30 countries and has killed 514. Beyond the human toll, it is wreaking significant economic damage across Asia. The Asian Development Bank estimates that East Asia could lose nearly 28 billion dollars in income and output if SARS is not controlled by September. Under such a scenario, aggregate 2003 GDP growth in China, Hong Kong, South Korea, and Taiwan would be cut from 5.6 percent (pre-SARS) to 4.7 percent, while growth in Southeast Asia would drop from 4.0 percent to 2.5 percent.

To date, Hong Kong is among the worst hit. Credit Suisse First Boston forecasts the economy is on course to contract 4.5–6.5 percent this quarter, threatening to derail plans to lower its critically high budget deficit. Taiwan's economy, battered by a quadrupling in cases since April 20, is reportedly contracting 1 percent during the current quarter. In Singapore and Thailand, 2003 GDP projections are being lowered 0.5–1.5 percent.

Nowhere is SARS having more impact than on mainland China, where the disease started. By May 9, over 4,800 cases and 230 deaths had been reported there. Yet its greatest impact may be on China's breakneck economic growth and antiquated political system. The epidemic's slow but seemingly unstoppable progression, and Beijing's long concealment of the truth, are exposing economic and political fault lines by simultaneously weakening the economy, damaging the government's credibility, and threatening social stability.

Neil Beck is a research assistant for the Strategic Asia Program at The National Bureau of Asian Research. The author acknowledges the valuable contributions of William Abnett, Richard Ellings, and Joseph Ferguson during the drafting of this report.

Beijing is now the epicenter of the crisis, both medically and politically. On March 26, authorities admitted for the first time there were SARS cases (10) in the capital. Even as late as April 15, the official number was a paltry 37. After facing blistering rebukes from the World Health Organization (WHO), the broader international community, and its own medical community, the party leadership finally admitted on April 20 that it had concealed the true extent of the crisis. Both the Minister of Health and the Mayor of Beijing were dismissed for negligence, and the government updated the number of cases to 339. By May 9, the capital's total had risen to over 2,177, with 114 deaths, although the number of newly infected persons has apparently dropped in the last few days.

For a population increasingly removed from the Cultural Revolution and the government's micromanagement of its citizens' personal lives, the last few weeks have been a startling adjustment in Beijing. More than 18,000 people are now quarantined in the capital. Makeshift roadblocks prevent residents from driving into the countryside, although students and migrant workers are fleeing on trains and airplanes. Entertainment venues, including bars and restaurants, have been closed or are being avoided. Public schools have been closed at least until May 21, and many colleges and universities have been shut down.

The impact is now spreading to other regions. The city of Nanjing, a critical pressure point for protecting the Yangtze river delta and Shanghai from economic paralysis, has quarantined 10,000 people, sealed itself to travelers from SARS-infected areas, and announced jail terms for residents attempting to hide symptoms. Shanghai reported its first SARS death this week and has ordered fourteen-day home quarantines for anyone entering from a SARS-infected area. The WHO is sending experts to Hebei province, where the number of infected persons doubled to 98 between April 30 and May 4, and added travel advisories for Tianjin and Inner Mongolia to the existing list of Beijing, Hong Kong, Guangdong, and Shanxi.

Economic Impact

China's economy is experiencing a significant impact from the outbreak, and projections are being revised as the epidemic continues. After rapid 9.9 percent growth in the first quarter, China's economy will purportedly shrink 2 percent this quarter. Many economists now predict China's annual growth will fall below 7 percent, the lowest level since 1990. The severity of the current downturn is yet unclear and will largely depend on the progression and length of the outbreak, its impact on long-term investment factors, and foreign perceptions of social and government stability.

The initial impact of the epidemic has fallen primarily on China's services sector, which is particularly vulnerable to consumer confidence and spending. The retail, tourism, hospitality, and entertainment industries have been stricken (average hotel occupancy rates are now reported to be 33 percent) as postponed foreign tourism and business travel is compounded by the shortened May Day holiday week, a ban on domestic tourism, and the recent closure of many of Beijing's entertainment venues. China has been somewhat shielded by the fact that its services sector only comprises a third of the economy, far lower than in Hong Kong.

Manufacturing, which accounts for half of all economic output, initially experienced indirect effects only. The fundamentals driving China's manufacturing power, particularly its low-cost, skilled labor pool, have not changed because of SARS, and foreign businesses have not pulled out of ongoing operations or reported significant disruptions (although Motorola recently closed its Beijing office temporarily). In addition, China's excess capacity and labor buoy prospects for the manufacturing sector. If disruptions occur in one region, other entities are reportedly prepared to enter the market relatively quickly.

Still, the sector faces considerable risks, and there is mounting evidence the economic impact is now reaching manufacturers. For the first time in over a decade, China may run a trade deficit in 2003. Several factories are reporting significant drops in orders, which instead are being routed to Southeast Asia, Turkey, and Mexico, according to Credit Suisse First Boston. Buyers in the United States, Australia, Japan, and Hong Kong are purportedly turning away from Chinese goods. For example, agricultural exporters in Hunan province reported an 87 percent drop in orders for meat products from Hong Kong and Australia during April (year-on-year). Russia has closed some border crossings with China and urged its airlines to halt all flights to the mainland, Hong Kong, and Taiwan, which could further slow trade.

SARS-related precautions are exacting a premium on the transport of goods across China. According to *The Wall Street Journal*, trucking costs are climbing on main arteries such as the Shanghai-Beijing route (one freighter cites a 66 percent increase for hiring a truck), partly due to medical checkpoints on the highways and special quarantines for trucks with Beijing license plates. Shipping by rail is often cost prohibitive and the timeliness of air transport is not guaranteed, since SARS-related air shipments currently have top priority.

Potentially more damaging in the long run, perceptions of China as a safe, predictable, and high-yield market for investment are now under review. China's mismanagement of the epidemic, and the perceived political and economic instability the leadership has caused, is at least temporarily dampening China's attractiveness to some foreign firms and investors. The value of new contracts for foreign investment could drop 50–80 percent in 2003, according to a recent estimate. Actual FDI in China grew by 56 percent year-to-year in the first quarter, but the frenzied pace of deal making has slowed dramatically in recent weeks.

- The Canton Trade Fair was cut short on April 19 with \$3.31 billion in signed contracts, less than 20 percent of last year's total.
- Signed contracts at the 2003 Guangzhou Trade Fair fell to \$730 million, just 4 percent of the 2002 total.
- Acer Inc. (Taiwan) said it will postpone plans to make notebook computers at Chinese factories.
- Electronics giant Matsushita Electric Industrial Co. (Japan) is reviewing its intention to increase its parts supply from China.

Barring a crisis-fueled economic collapse, however, foreign firms and investors largely remain optimistic about China's long-term attractiveness. General Motors continues to invest in new Chinese plants while shedding capacity elsewhere, and several key international players in China's hotel

industry have vowed to continue their expansion plans, arguing that the sharp current decline is merely a short-term phenomenon.

Regardless of that optimism, the risks are high enough that the government is now moving to blunt the economic damage. According to press reports, the Cabinet approved an emergency package on May 8 that offers tax breaks to SARS-affected industries including the travel, tourism, retail, and hospitality sectors. The party reportedly banned firms in affected areas from “firing employees at will” and said workers whose income fell below the poverty level would be eligible for government assistance. These policies are not without long-term costs, however. While the increased public borrowing and spending needed to support the stimulus package could diminish the short-term impact from SARS, the measures could also slow China’s efforts to restructure its state sector and clean up the debt-ridden state banks. In reference to long-term impacts, a Chinese government researcher, writing in the *China Daily*, warned of lower productivity and consumer spending combining to erode profits and force significant layoffs, a gloomy scenario that could damage social and political stability.

Political Impact

Beijing’s mismanagement of the outbreak has plainly exposed just how far political reform has lagged behind economic development. The crisis is undermining traditional supporters, aggravating old demographic strains, and emboldening detractors to more assertively protest government policy. Because of China’s growing interdependence with the world, the current maelstrom is more likely than previous crises to lead to political reforms, but the extent of those reforms will depend on the duration of the epidemic, the severity of the economic impact, and proclivities of the Communist Party that so far appear unaltered by public outrage.

Even the government’s most consistent supporters are dismayed by Beijing’s apparent dishonesty. Many in the rising middle class, which now comprises 15 percent of the population and generally supports the government, now feel betrayed after trusting Beijing’s initial assurances. Some also condemn the government for acting only because of international pressure and not out of concern for public health.

Other voices traditionally counted on for support, or at least silence, have become vocal critics of the government. Dr. Jiang Yanyong, a retired surgeon at a prominent military hospital, wrote an open letter on April 4 accusing the government of concealing the true number of cases and the actual danger posed to society. That letter encouraged other colleagues, as two staff members at another military hospital subsequently alleged their facility was hiding SARS patients from the WHO to protect the flow of tourists and investment to Beijing.

College students, who have also benefited from China’s breakneck growth, are now beginning to question party leaders and are acting more assertively than their predecessors did over the last decade. Fearful for their health and angry at the government’s mismanaged response, they have called for the cancellation of classes, demanded school administrators do more to protect them, and voiced frustration with the government-ordered quarantine.

The mass population, increasingly burdened by ongoing economic reforms, appears emboldened to protest government decisions and lack of communication.

- In mid-April, northern Beijing residents blocked the gates of Heping Hospital after hearing the facility would be used for SARS patients. The hospital is now closed for renovation, but people in surrounding villages still believe the building has been quarantined with SARS patients inside.
- On April 28, thousands of residents of Chagugang (a rural agricultural town northwest of Tianjin) ransacked a local school they suspected had been designated to become a ward for urban SARS patients. Amid signs of rural/urban tension, residents were furious with the lack of government consultation.
- On May 4, villagers in Xiande (in Zhejiang province) broke into a government building where suspected SARS patients were being quarantined. They destroyed windows and furniture and injured three officials.
- On May 9, 60 people protested in Beijing against plans to set up a fever station at a neighborhood hospital, the first known SARS demonstration in the capital.
- In rural areas of the massive municipality of Chongqing, villagers fearful of SARS have repeatedly ransacked quarantine sites.

Still, China has faced other crises in confidence, such as the Tiananmen Square crackdown, that have not led to significant political reform. Unlike those challenges, the current outbreak is more potent because it endangers the foundation of the Communist Party's legitimacy—meeting the public's expectations of safety and rising living standards.

Since beginning its economic reforms, China has increasingly benefited from global interdependence and the modern world's free flow of goods, capital, and people. However, with those benefits come the responsibilities of accountability and transparency to foreign investors and business entities. China's reaction to the outbreak has exposed the dearth of both characteristics in its political system, and the resulting drop in foreign confidence (the extent of which is somewhat clouded by Warren Buffett's recent large purchase of PetroChina stock) is having an immediate impact on China's economy. Still secretive and unchecked, China's excessively rigid political system could eventually threaten the foreign capital flows and trade that are critical to continued economic growth and internal stability.

The party, led by President Hu Jintao and Premier Wen Jiabao, is now moving quickly to counteract the loss in confidence. Before the SARS outbreak, Mr. Hu portrayed himself as a populist leader, visiting workers and promising to narrow the growing gap between the urban rich and rural poor. Now he and the Communist Party have been forced to embrace several powerful concepts:

- Political accountability. Minister Zhang and Mayor Meng were the highest-profile officials fired for negligence—instead of corruption—since Communist Party General Secretary Zhao Ziyang was removed during the Tiananmen protests. Another 120 officials have been fired, demoted, or reprimanded in the last month.

- Transparency. From Premier Wen to new Beijing Mayor Wang, the message is consistent: the public must be told the truth regarding matters directly affecting their lives. In what might be a sign of changing times, the asphyxiation deaths of 70 People's Liberation Army (PLA) submariners were reported in the PRC official press on May 3, a highly unusual act of openness.
- The government must provide a more adequate social infrastructure. The outbreak has exposed a major flaw in China's model for growth, namely that public infrastructure could be ignored in favor of maximizing national income. Greater investment has been promised in public health care (\$420 million alone to set up a nationwide health network) but will increase fiscal pressure on the new PRC leadership that already inherited sizable and rapidly accumulating public debt.

Still, several important forces in Chinese politics that contributed to the crisis appear unaltered and could weaken any push toward greater accountability and transparency. First, factional politics remain a decisive force in political legitimacy and authority. The incomplete transfer of power from former president Jiang Zemin to President Hu Jintao has left their rival supporters jockeying for influence, and President Hu and Premier Wen are now using the crisis to consolidate their power base. Although the April 20 dismissals of one Jiang confidant (Minister Zhang) and one Hu ally (Mayor Meng) were apparent tradeoffs among the factions, Mr. Jiang's reputation has suffered in recent days. During an April 26 speech, he claimed the government had scored important victories against the outbreak. Those comments, which directly conflicted with Mr. Hu's and Mr. Wen's nightly statements of the grave struggle ahead, were met by significant public criticism. If President Hu and Premier Wen emerge from the crisis with greater power, they may have more levers at their disposal to discourage reform efforts.

Second, local governments and turf-conscious bureaucracies have been remarkably successful in resisting and ignoring previous reforms and directives from the central government. Their continued success will depend in part on the level of pressure exerted from top leadership, and neither President Hu nor Premier Wen have given many signs that he is a committed reformer.

Third, because the party still controls the state media and oversees online content, it can exert significant control over what the domestic audience hears and how it interprets that information. So far, the party does not appear willing to let go of the information spigot yet. Several newspapers continue to bury new numbers of SARS cases on their inside pages. The *People's Daily* ran the dismissal announcements below the front-page fold and offered no explanations, leaving the impression the party was printing the news "in a place where people could ignore it." The advocacy group Reporters Without Borders stated last week that two senior editors were fired and the foreign desk staff docked three-months pay for publishing a government report on measures taken to fight SARS.

Conclusion

A number of observers and pundits are considering whether SARS might be China's Chernobyl, a landmark catalyst for political and economic reform. There are clear parallels. The Soviet government attempted to hide the disaster until international pressure forced Moscow to disclose the truth, and similar to President Hu, Mikhail Gorbachev encountered the crisis within his first year in power.

There are also strong differences between the two cases. Mr. Gorbachev came into power waiting for an opportunity to implement glasnost and perestroika, but China has no leading reformer just entering the political stage. While the Soviet economy was in a headlong decline by the 1980s, China is experiencing rapid growth with bright prospects, in part due to comparative advantages unlikely to change because of SARS. Also, while Beijing has faced significant international pressure, it is so far not facing the vitriolic condemnation the world directed at Moscow after Chernobyl.

Thus, while growing pressure from a more demanding public and an increasingly interdependent world has forced China to stop concealing its crisis, the extent of any resulting political reform will depend on whether the enhanced incentives for accountability and transparency among public officials override the traditional incentives for party and factional loyalty. What is clear, as evidenced by Premier Wen's humble pledge of candor last week to ASEAN, is that the calculus of Chinese politics—including factional politics—is in flux. As China continues to integrate with the world economy and accepts other global values, pressures for political reform mount.



THE NATIONAL BUREAU OF ASIAN RESEARCH

4518 UNIVERSITY WAY, NE
SUITE 300
SEATTLE, WASHINGTON 98105

206-632-7370 PHONE
206-632-7487 FAX

nbr@nbr.org
<http://www.nbr.org>