Chapter 4

The Outlook for China and the World Economy, 1995–2015

As a consequence of successful policy in the reform period, Chinese per capita income rose by 6 per cent a year, faster than any other Asian country except Korea, very much better than the 1.5 per cent a year in the United States and the other advanced capitalist countries, and six times as fast as the world average. China's per capita GDP rose from a quarter to half of the world level. Its share of world GDP rose from 5 to nearly 11 per cent, and it became the world's second biggest economy after the United States.

At the end of the twentieth century, however, China is still a relatively poor country. In 1995 its per capita income was only 11 per cent of that of the United States, 13 per cent of Japan, 20 per cent of Taiwan, 22 per cent of Korea and 45 per cent of that in Thailand. Countries in China's situation of relative backwardness and distance from the technological frontier have a capacity for fast growth if they mobilise and allocate physical and human capital effectively, adapt foreign technology to their factor proportions and utilise the opportunities for specialisation which come from integration into the world economy. China demonstrated a capacity to do most of these things in the reform period, and there is no good reason to suppose that this capacity will evaporate.

It is likely therefore that China will continue the catch-up process in the coming decades, but it would be unrealistic to assume that its future growth trajectory will be as fast as in 1978-95. In assessing future prospects for growth and China's international standing, we must consider the constraints which are likely to be important within its domestic economy, and examine the world context in which China will have to operate.

Outlook for the Chinese Economy

The three big domestic problems which emerge from our analysis in Chapter 3 are the need: *a)* to shut down a very large number of loss-making state enterprises; *b)* to transform the financial system which operates with an important and increasing proportion of non-performing assets; *c)* and to strengthen the weak fiscal position of central government. These are classic problems in the transition from a command to a market economy. The failure to solve them in most of the economies of the former USSR was a major reason for their dismal performance in the 1990s. It is clear that such problems run very deep. Compression of state enterprise will create major problems for a substantial portion of the urban population which has hitherto enjoyed a relatively privileged position, but will need to find new sources of employment and income. Transformation of the financial system will require a major change from bureaucratic attitudes and procedures to the professional risk assessment which characterises investment banking. Remedying the fiscal weakness will require delicate negotiations between central and lower levels of government which have eroded the tax base by a welter of tax concessions and reliance on extra-budgetary sources of income.

The top Chinese leadership are well aware of these problems, and appear to be committed to changing the situation. It is clear that effective action will require a prolonged period of cautious macroeconomic policy in which improved resource allocation should be given greater priority than high rates of investment.

In the reform period, China was able to increase employment twice as fast as population, because of changes in demographic structure which raised the proportion of people of working age, and substantial increases in the activity rate for women. The scope for such changes will be more modest in future. There is also likely to be slower improvement in the educational level of the labour force which was multiplied by a factor of five from 1952 to 1995, and is unlikely to rise by more than a third by 2015. Thus one might reasonably expect quality adjusted labour input to grow by 2 per cent a year from 1995 to 2015, compared with more than 4 per cent in 1978-95 (see Table 3.10).

One can reasonably expect slower growth of labour and capital inputs, and total factor productivity is unlikely to be better than in 1978-95, when there were exceptional gains in agriculture (see Table 3.14). For these reasons one can expect China's GDP growth to slow down from 7.5 to 5.5 per cent a year, and per capita growth to be about 4.5 per cent instead of 6 per cent. With such performance China would probably reach US levels of GDP by 2015, would account for about 17 per cent of world GDP and have a per capita income nearer to the world average. It would still be a relatively poor country with one fifth of US GDP per capita, but its role in the world economy and its geopolitical leverage would certainly be greater.

Outlook for the World Economy

Tables 4.1 and 4. 2 provide a condensed but comprehensive survey of the performance of different parts of the world economy from 1952 to 1995, together with a rough assessment of their growth potential in the twenty years 1995 to 2015.

Separate estimates are given for the four biggest economies — China, India. Japan and the United States; the other 213 countries are allocated to eight multi-country groups which have some degree of internal congruence in terms of growth performance and levels of income.

It is clear that developments in the world economy have been quite complex and would be difficult to explain with a simple economic model.

Over the years 1952 to 1978, world per capita income grew faster than ever before, at 2.6 per cent a year — 28 times as fast as in 1700-1820, and 3 times as fast as in 1820-1952. In this golden age, all parts of the world economy showed substantial improvement on past performance. The United States — the lead country in terms of productivity and per capita income — grew more slowly than the world average, but continued to experience relatively high rates of total factor productivity growth which can be taken as evidence of rapid advance at the technological frontier (see Table 3.10). There was a remarkable degree of catch-up in Japan and the advanced capitalist countries which substantially reduced the per capita income gap between themselves and the lead country. There was significant catch-up (from lower levels of income) in the Middle East, "Dynamic Asia", Eastern Europe and the USSR. In China, real income grew faster than ever before, but its growth was less than the world average. Africa and "Other Asia" fell behind in relative income, but also increased their absolute levels at historically unprecedented rates.

In 1978-95, world economic growth was much slower. The deceleration in the lead country was mainly due to a sharp drop in total factor productivity performance, suggesting strongly that the pace of advance at the technological frontier had weakened. There was a sharp slowdown in Japan and the other advanced capitalist countries, because of the weaker growth at the technological frontier and the

fact that they were operating much nearer to US levels of performance and hence had eroded a good part of their potential for rapid catch-up.

The Asian economies were the most dynamic component of the world economy in 1978-95. Growth of per capita income accelerated sharply in China and the 7 other dynamic Asian economies. There was substantial improvement in India, but some slowdown in the 31 other Asian economies.

If the world economy had consisted only of the countries represented in the first seven rows of Tables 4.1 and 4.2, one could have interpreted the pattern of development as a fairly clear–cut demonstration of the possibilities for "conditional convergence" suggested by neo-classical growth theory. Growth had slowed down in Japan and the other high income countries, as their scope for catch-up waned, and it accelerated in a significant number of Asian countries where incomes and productivity were a good deal lower, and the scope for catch-up was correspondingly quite large. This was not an automatic or generalised process. These lower income countries could exploit their catch-up potential only because they adopted policies propitious for growth, mounted high rates of investment in physical and human capital, increased labour force participation, opened their economies to foreign trade and specialisation, pursued macroeconomic policies which smoothed the growth process, and microeconomic policies which promoted increased efficiency of resource allocation. Such policies were more or less characteristic of China and the dynamic Asian economies in 1978-95[1].

Growth theory provides little help in explaining the experience of the other five groups shown in Tables 4.1 and 4.2. Their 1978-95 performance was abysmal. Latin America had the least depressing situation, but its per capita growth was only one tenth of that in 1952-78. In the other four groups, absolute levels of per capita income dropped substantially. Taking all five groups together, their per capita income in 1995 was about 23 per cent lower than in 1978. A setback of this scope, duration and dimension is without historical precedent, and was a startling manifestation of very significant divergence in the pattern of world economic growth. These economies suffered major shocks which crippled their growth momentum and left their economic policy in disarray. The biggest of these system shocks was the political and economic collapse that accompanied the disintegration of the USSR into 15 independent states. This shock also led to political change in East European countries and to the collapse of their command economies. In the Middle East, Latin America and Africa, growth in the golden age had not been due to any great virtues of domestic policy, but was significantly dependent on the diffusion effects of high growth momentum in the advanced capitalist countries. The sharp slowdown in the capitalist core sparked off debt crises, inflation, fiscal and monetary problems in Latin America and Africa. In the Middle East falling oil prices and wars affecting Iran, Iraq and Lebanon were major disturbing forces.

In assessing the prospects for 1995-2015, the demographic estimates (medium-variant) of the United Nations Population Division were used, except as noted in Table 4.1. For per capita income the following assumptions were made. It is likely that progress at the frontier of technology will continue to be slow, in line with the evidence of slow total factor productivity growth in the lead country (the United States) which has been evident for the past quarter of a century. It is assumed that the other advanced capitalist countries and Japan will have little potential for significant narrowing of the real income/productivity gap between themselves and the United States. This is now fairly small, and economic policy in both Japan and the advanced capitalist countries of Europe has been and is likely to continue to be less than optimal for realising their full potential (see Maddison 1997). It does not seem unreasonable to hope for some reversal of the previous declines in per capita income in the countries of the former Soviet Union, the Middle East and Africa, and there are already signs of revival and some success in policy reorientation in Eastern Europe and Latin America, where somewhat better growth is forecast. Deceleration in the dynamic Asia group seems likely as some of the countries have already arrived at levels of income where the pace of catch-up can be expected to

wane, and several of them have very serious problems of adjustment to the system shocks of 1997 (flight of foreign capital, collapse of stock markets and exchange rates, escalating inflation and IMF stabilisation programmes) which are likely to have repercussions for several years. In other Asia, where incomes are much lower, there is potential for growth acceleration of the type already evident in India. China seems likely to be able to grow faster than most other Asian countries *a)* because its level of real income/productivity is quite low; *b)* it has sustained a high growth trajectory for two decades and has proved capable of maintaining high rates of investment in physical and human capital; and *c)* it has been less exposed to the shocks which other dynamic Asian countries sustained in 1997. However, future growth is unlikely to be as fast as in 1978-95 because it faces major problems in reforming state industry, fiscal, and monetary policy; has eroded some of the once-for-all gains from previous liberalisation; and faces some slowdown in its Asian markets.

The overall world projection suggests slower demographic growth than in 1978-95, but a significant improvement in the overall growth of per capita income. World GDP is projected to grow at about 3 per cent a year. This would be better than the 2.7 per cent of 1978-95, but substantially slower than in 1952-78.

Note

1. In analysing growth performance and potential, it is useful to go beyond the estimates of per capita product presented in Tables 4.1 and 4.2. Growth accounts such as those in Table 3.10 for China, Japan, Korea, and the United States are a basic guide to such analysis, as they illuminate the causal processes of economic growth, and provide some idea of the role of factor accumulation and factor productivity. Unfortunately they require a good deal of information which is not available in many countries, as well as careful adjustments to ensure international comparability. There are a number of studies using cross-country regressions which rely heavily on poorly documented or proxy measures of uncertain quality, particularly for the capital stock. Collins and Bosworth (1996) is probably the best of these. Young (1995) provides more rigorous and better documented growth accounts for four of the dynamic Asian economies for 1966-90. His approach has a family resemblance to that used in Table 3.10, but he has a different periodisation and a more complex analysis of labour and capital inputs. Although his procedures and sources are carefully described, his accounts are not transparent enough to recast them using my simpler procedures. Nevertheless, his results, and his interpretation of them, seem quite coherent with that found in an earlier 14 country analysis in Maddison (1989, pp. 81 and 91). His basic conclusion is that the extraordinarily fast growth of the dynamic Asian economies was due primarily to success in mobilising labour and capital resources and that their total factor productivity performance was respectable but not extraordinary by postwar standards. Young's work inspired Krugman's (1994) attack on the notion of an Asian "miracle". This was a useful riposte to the overly euphoric World Bank (1993) study, but Krugman's assessment was too bleak. He seized on the outlier results for Singapore as if they were representative of Young's sample. He suggested that the achievement of the dynamic Asian economies was no better than that of the USSR (quite implausible in the light of Table 4.1).