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REFRAMING CHINA POLICY: THE CARNEGIE DEBATES

Debate 2: China's Economy

Motion: Without significantly accelerated reforms and major new policy actions, China's rapid growth will unravel before its economy overtakes the U.S.

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Arguing Against the Motion:

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1. Introduction

Although China and its economy face enormous problems, China is on track to enjoy continued rapid growth. Given the enormous Chinese population, this inevitably means that the aggregate size of the Chinese economy will approach and eventually overtake that of the US. Simple extrapolation of past trends is not an adequate guide to the future; but analysis of the current situation leads us to conclude that conditions for future growth are at least as good as past conditions have been.

If we look backwards, we see many cases where outside analysts, looking at Chinese growth, have pointed to serious problems with China's policies, institutions, and capabilities. These analysts have predicted the collapse of China's growth, perhaps the collapse of the Communist Party regime, and the unmasking of the "phony" Chinese model. So far, these critics—let's call them "China skeptics"—have never been right.

To be frank, when Wing Woo agreed to argue the affirmative case in this debate, I expected he would argue from a China skeptic position. To my surprise, I find that he does not, and in fact there are substantial areas of agreement between Wing and myself. If I understand Wing's argument correctly, it goes as follows: China needs to roll out major new economic policies to sustain growth. If it does not do so, growth will not be sustained. But, Wing apparently believes, policies already rolled out qualify as the kind of major new policies needed, and therefore as long as there is follow-through on these policies, growth will not unravel (although the very last statement was not explicitly made in the briefing paper I saw this week, and is subject to caveats about the environment and, especially, global warming).

This is similar to how I see things. Later on, I'll emphasize some of the differences in our views, but let me start by emphasizing some of the commonalities. We both see a China with enormous growth potential, yet with enormous problems. For both of us, China's success is due to resilience and flexibility in policy-making, a willingness to shift gears when necessary to confront different kinds of problems. And we both (I think) expect that resilience and flexibility to continue, and to be adequate to cope with even the daunting problems that China faces. The difference between us is straightforward: Wing thinks that growth sustainability depends on the Communist Party delivering a package of correct policies, and he thinks the Communist Party has already committed to the right package of policies. I don't think the Communist Party has made any such commitment, and I don't think it's likely they will make such commitments until, or unless, they're forced to do so. However, I don't think that growth depends on Communist Party blueprints.

2. The Growth Context

It's a good thing that people who seriously study the Chinese economy can agree on China's growth potential. After all, China's past growth experience has been overwhelming: China has now grown faster, longer than any other large economy in

history. Moreover, China's growth has not significantly faltered since the reform program kicked into gear in the 1980s. Since the beginning of reform, China's official GDP growth has been almost precisely 10% per year. Taking into account probable statistical overstatement, China GDP today is **ten** times as big as it was in 1978, at the beginning of reform. China's growth has already been sustained: When we discuss future growth we're actually asking whether China's growth will be sustained again!

Let's pause for a second to look at the simple foundations of growth, and lay out two future milestones. The growth of an economy is basically determined by the growth of inputs, combined with the increase in efficiency with which those inputs are used. China today is undergoing an astonishing and historically unique experience of an extraordinarily rapid increase in all of the inputs into the economy. Labor is growing extremely rapidly. Because of the impact of the one child family policy, the proportion of the total population in the labor force is unusually high, between 2000 and 2015 this proportion is over 70 percent (about ten percentage points higher than the average middle income country). With low dependency rates, China enjoys an especially large "demographic dividend," that window of opportunity that comes when a baby boom enters the labor force. That effect is magnified in China because the urban economy is now large enough to absorb substantial inflows of labor from the countryside, so that the growth impetus from "structural change" (rural to urban) is now at its peak. As a result, the urban labor force has been growing at a whopping 4% per annum since the late 1990s.

This huge surge of productive labor presents an enormous challenge. If these workers cannot be equipped with adequate human and physical capital, the opportunity to springboard to modernity will be lost. For years, China's educational commitment was mediocre at best. But since the late 1990s, China has turned it around. The number of annual college graduates has *tripled* since 2001 to over 3.5 million (including junior college graduates). Even more fundamentally, China has put in place a program that will extend central government financing for 6-year primary education to all provinces. Human capital per worker is now increasing quickly, and is on track to accelerate over the next decade. What about physical capital? Here the performance is even more startling. For the past three years, China has invested more than 40% of its GDP in fixed capital formation. It is the highest investment rate ever recorded for a large economy. The result is that the sum total of highways, houses and factories available per worker is increasing rapidly.

With this rapid growth of inputs, all that needs to happen for the Chinese economy to sustain "hyper-growth" is for productivity growth to be positive; it doesn't need to be stellar. In fact, according to the quite skeptical analysis in Young (2003), China's non-agricultural total factor productivity growth from 1978 through 1998 was 1.4% per year; Holz (2005), in a more detailed study, puts it higher. Moreover, productivity growth has certainly accelerated since 1998. Remember, too, that productivity begins from a relatively low level. China even a decade ago was a quite backward economy with inadequate institutions, low skills and experience and, as a result, low productivity. With rapid institutional change, it's fairly easy to maintain moderate productivity growth, and China will definitely continue to do so. Rapid growth of inputs will continue until about

2015, and this, combined with continued moderate productivity improvement, means that the aggregate size of China's economy will significantly surpass that of Japan, making China the world's second largest economy and, given geography, the dominant power in Asia.

After 2015, the growth of inputs will slow. Aggregate labor force growth drops to zero, due to the delayed effects of the one-child policy. Urban labor force growth continues, but at a much slower pace, as the reservoir of young under-employed rural workers is drawn down. An older society with a larger share of elderly dependents makes more demands on the economy. Thus, even in a highly positive scenario, we should expect growth to ease off from hyper-growth (over 8% per year) to just rapid growth (say 6% per year). By 2035, when urban labor force growth drops below 0.5% per year, Chinese GDP will be about 18 trillion of today's US dollars. That's bigger by half than the US economy today, but if US growth continues, at even 2% per year, US GDP would be bigger still, at about 22 trillion. But from about that time, the Chinese economy is in range of the US economy, and will probably still be growing substantially faster, even though the growth rate differential will no longer be as large as it is today. In other words, in thirty years China will catch up with the US in aggregate size, and be positioned to overtake. While the specific numbers are not precise, the overall picture is quite robust. My argument is simple: China's growth will not unravel, and we should be prepared for this scenario. Given these powerful fundamentals, the Chinese government mainly needs to remove obstacles to growth, and support market forces tending to strengthen property rights and competition. The growth scenario does not depend on the success of a specific package of policies being introduced by the Chinese government.

3. Communist Party promotion of a “Harmonious Society” will not be the crucial determinant of whether China keeps developing.

In the past two years, the Chinese Communist Party has articulated a coherent new policy blueprint of a “harmonious society.” Multiple programmatic documents now call on the government to enact policies that are favorable to rural development, enhanced health and social security protection, decreased regional inequality, and a more environmentally-friendly development strategy. These policies are greatly to be welcomed (Naughton 2005). They are important, and they are an essential, and long overdue reaction to serious and widely-accepted problems in Chinese society, most obviously the dramatic increase in income inequality that has seen China's Gini coefficient soar from the very equal 0.28 in 1983, to a quite unequal 0.447 in 2001 (Ravallion and Chen 2004). These policies represent an important shift of emphasis from growth for its own sake to a broader stress on the quality of life and on personal security as well as personal consumption. However, we should also take these policies with an appropriate degree of skepticism: these are expressions of good intentions. In some cases they will be followed through, in others they will not. Over the past thirty years, China has seen many economic successes, but also many government policies that came to nothing. We should expect the same mix of success and failure from the current grab-bag of harmonious and people-friendly policies.

Moreover, it is very important to stress that these proclamations simply do not say what Wing Woo claims they say. Wing says that “the first component of a harmonious society is identified as ‘a democratic society under the rule of law.’” And he refers to “Hu-Wen’s switch to democracy.” This would be wonderful news if true, but it is not true. Neither the communiqué nor the full resolution refers to “democratic society under the rule of law.” The official English translation says “the socialist democratic and legal system is further improved,” a far more equivocal commitment, which is merely a continuation of the rhetorical commitment to a sham “socialist democracy” that has been promoted by the Chinese Communist Party for years; no, for decades. There is nowhere in this resolution any clear commitment to any sharing of the Communist Party’s monopoly on power, or to a real democratization that would be recognizable to the people in this room. Moreover, there are repeatedly declarations that Communist Party leadership is the core of the creation of a harmonious society, and one ringing call to “uphold the organic combination of Party leadership, the people as master of their own house, and ruling the country through law.” (CCP Resolution, Section 6:1). In the Chinese context, this is progress, but it isn’t democracy.

Exactly what are the policies that are essential to create the harmonious society? The Communist Party resolution doesn’t say. In fact, it declares that “today, Chinese society overall is harmonious.” (CCP Resolution, Section 1). There’s nothing in the CCP resolution or in Wing’s paper that enables us to answer the question of which policies are necessary. Moreover, we have no way to judge the level of commitment of the CCP to any of the specific policies. When policies prove to be ineffective or run into resistance, which will be intensified, and which abandoned? If the CCP does decide to liberalize, will they be willing to accept what they hear the people say, or will they back-pedal when people start criticizing the Communist Party? And finally, how will they react when implementation of some of these policies turns out to have a negative impact on markets and be harmful to economic growth? Commitment to a harmonious society at that point simply won’t be enough.

4. What specifically are the “significantly accelerated reforms and major new policy actions” that we absolutely must see to keep growth on track? In fact, there is no single policy prescription.

It’s not all clear what the “significantly accelerated reforms” that Wing thinks are essential should be. Wing has written eloquently about environmental deterioration in China, and about the importance of democracy as an ultimate goal. But what needs to be accomplished in the near future to keep growth from unraveling? Wing doesn’t call for any of the specific policies that most critics of China would urge as priorities. Wing doesn’t call for privatization; or complete overhauling of the financial system. He doesn’t demand an opening of the capital account, immediate RMB appreciation, or a shift to a floating currency. He doesn’t call for privatization of the pension system; overhaul of the tax system. And he certainly doesn’t call for any specific political reform or for the end of Communist Party monopoly of political power. On the contrary, he seems to think the Party is taking China in the right direction.

What is it about economic policy that is most important, then, to the Chinese economy? I argue that it's not about the leadership having the correct policies. Rather what is essential is that the Chinese government, in its own interest, be responsive to the immense and unceasing stream of economic challenges to which China is subject. Because China is huge and still poor, leaders who want to survive, maintain power, and pass wealth on to their children and friends, have been compelled to adapt to economic challenges, or face crisis and the collapse of their power. Once the Chinese Communist Party began to open up the huge and diverse Chinese economy to competition, they started down a slippery slope to cumulative liberalization and opening. With the emergence of a vigorous non-state economy and the growth of diverse interest groups, the Communist Party was faced with a simple choice: accommodate growth and keep it going; or try to turn back the clock. This choice was not much of a choice, in reality, and once the Communist Party decided to accommodate that growth, the crucial story has been the ability of the Party to respond to specific challenges when they became overwhelming. In other words, continued growth doesn't depend on the Party designing a harmonious society, it depends on the Party being willing to concede and co-opt the economic forces that demand change. So far, that's exactly what's happened. Let's shift perspective to make this point more clear.

5. Flexibility and responsiveness.

In the past, "China skeptics" have repeatedly analyzed serious problems with the Chinese economy. For example, Lardy (1998), a path breaking work, uncovered the fundamental financial condition of China's state-run banks, demonstrated their underlying insolvency, and predicted a serious financial crisis. Was Nick Lardy wrong about China's financial system, because he predicted a financial crisis that did not come to pass? No, he was not. Quite the contrary: Lardy was proven right in every one of his descriptive and analytic dissections of the Chinese banking system. The system was just as hollow and flimsy as Lardy described, and was indeed 'technically insolvent.'" Moreover, Lardy was the first to point this out, in a comprehensive manner, either inside or outside China.

But why then has Lardy been wrong in predicting an impending financial crisis? Quite simply because Lardy did not anticipate the vigor and effectiveness of the Chinese response to its financial system weakness. The irony is that it was precisely the vigor and clarity of Lardy's critique; the influence that it exercised abroad; and the alarm that it caused in many quarters that finally roused the Chinese government to action. The irony is that a critic like Lardy, even when his specific prediction may be wrong, contributes more to the successful resolution of problems and the maintenance of a strong growth path than the smug defenders of everything right with the Chinese model, or those who praise Communist Party paternalism. Once the alarm bells are ringing, the system has an ability to respond and put out fires.

This is what has happened in the Chinese financial system. With their backs to the wall, the Chinese government poured money into the bank system. At least US \$350 billion has been pumped into the state banks, about a third of GDP at the end of the 1990s. Moreover, policy-makers laid down the law for the banks, offered a mixture of carrots

and sticks, forced them to reform and restructure, but also allowed them to go the markets and raise an enormous amount of money and attract some very important foreign strategic investors. This has been an enormous success for the Chinese, and the details have been much reported in the *Wall Street Journal*, *New York Times* and the *Financial Times*. Of course, this doesn't mean that the problems in the financial system are over, but I will return to that in a minute.

The point is not that China has no problems. For certain, China has many serious problems. But the record so far indicates that along with problems, the Chinese system also has the capability to focus policy-making ability and substantial resources on a few of the most serious problems, once they have been able to identify them as problems. China is in no way a democracy, but the Chinese Communist Party has learned that newly emerging economic forces present long-run challenges to Party power while also offering the only possible route to prosperity. In order to forestall challenges, the Party has developed the capability to listen to its own people and its critics, and build a rough consensus from time to time about what desperately needs to be done. And when it achieves that consensus, it acts on it.

Before the restructuring of the banking system, there was an even more important example of this process. After reform started, the base of the Chinese taxation and fiscal system eroded steadily for almost twenty years. In the early 1990s, the Chinese state faced a truly daunting crisis of effectiveness, as budgetary revenues, as a share of GDP, declined from 35% to 12%. This was the period when China skeptics were most vocal about the crisis in Chinese government effectiveness, and the possibility that China would simply unravel. But instead, faced with a challenge that focused their attention, China's leaders, led by Zhu Rongji, came together in a fundamental tax reform that shifted to a broad-based value-added tax. Shortly thereafter, they began cutting the ties to loss-making state-owned enterprises, staunching the subsidy drain, and killing of "zombie firms" that were dragging down the budget. Put together, these reforms turned around the overall fiscal picture, so that budgetary revenues have increased to 20% of GDP. This gave the government sufficient money to bail out the banks, and by cutting the cords linking loss-making firms to banks, gave the financial system at least an opportunity to recover.

Which issues really matter today? One thing we can say about a challenge to China's growth is this: If everybody's already talking about it, it probably means that it's beginning to be addressed. One example is the huge challenge of water availability that, as Wing Woo rightly points out, threatens China's future growth. The huge mobilization of resources needed to cope with this problem has begun. Woo points out that up until 1998, the flow of water in the Yellow River was interrupted scores of times as withdrawals exceeded supply, and it shocked the country. What he doesn't bother to mention is the fact that since 1999, this has not recurred, despite continued droughts, due to draconian controls on water usage. There are vigorous debates over the wisdom of specific measures to transport water from South to North China. What do these debates show? That the decision has been made to commit the resources necessary to address this problem, and that the fiscal situation means that the resources are available. There's

no room for complacency, but there is room for cautious optimism. Water is not going to derail the Chinese growth process, because the Chinese government will be forced to undertake the expensive investments and policy reforms necessary to ameliorate the problem.

6. Lag Effects Matter

Lags between the time when policies are adopted, and when they have effect, are very important. China in the late 1990s take many small policy steps in order to be ready to enter the World Trade Organization (WTO). Those policies interacted with state sector downsizing in the mid-1990s to create significant pain. But these policies laid the ground work for the search in economic growth after 2002. WTO created new rules and expectations, and growth surged forward as those rules went into place. Today, China still faces daunting problems, but in many cases when we examine the policy situation, we see that measures have already been taken that will begin to address the problem.

The financial system is the most obvious case. The system isn't fixed, but there's a difference between spending more than you earn when you have money in the bank, and when you don't. The Chinese financial system now has some of its own money in the bank, so to speak, and so it has several years, a window of opportunity to bring up standards and deal with ongoing problems. In the meantime, an external force for progress has been created by the commitment to allow competition from foreign banks as of December 11 of this year. Of course, the Chinese will slow that opening, and make sure that a sudden in-rush doesn't swamp their fragile financial boats. But they've built in a process of competition to keep reforms moving ahead.

This dynamic is at work in many areas. For example, the Chinese state has hung on to ownership of several hundred of the largest industrial and communications companies. Firms have been partially privatized, usually by selling off stakes in subsidiaries. But the government's hand is still dominant. This has short-run benefits for the state, because these companies have been able to defend protected markets (for example, in telecom and energy) that give them high margins and plenty of money to invest. But now that most of the transition to a market economy has been achieved, these firms can move forward with further restructuring and ultimate privatization. In fact, the policies are beginning to be put in place to restructure these corporations (by SASAC, the State Asset Supervision and Administration Commission), clarify the relations of ownership and control, and subject them to market discipline. It will be a long process, though, because all kinds of economic interest are at stake, and powerful stake-holders, in some cases high in the Communist Party, will fight defend those interests. The process has barely begun, but it is under way.

A further example is that related to changes in the fiscal system to boost education, combined with increased outlays for research and development, plus the early steps in creating some type of intellectual property protection (inadequate, to be sure, from the perspective of American companies that own today's intellectual property; but adequate for the future Chinese companies that will have intellectual property). Financial fragility

is significantly offset by a robust (to put it mildly!) accumulation of foreign exchange reserves, a nice US \$1 trillion cushion against the things that can still go wrong.

What are the serious challenges, then? In general, they are the unforeseen things, the ones we (and the Chinese government) haven't had a chance to prepare for. However, we can clearly see one area that will trouble the Chinese growth path. The enormous investment effort currently underway has huge benefits for the economy, but it also creates unavoidable risks. The most important near-term vulnerability of the Chinese economy is the extraordinary dependence of the economy on high investment. High investment creates robust demand for heavy industrial products, inducing still more entry and new capacity creation. While this is stable as long as investment keeps growing, it must inevitably run into limits. The process of adjusting to a new growth path with a stable, lower investment rate is the most economically challenging problem, because it is quite likely to happen through a sudden, sharp recession. Moreover, some adjustment is unavoidable, although the timing is difficult to predict.

At some point, the Chinese economy will shift gears, making a transition to a more consumption-friendly growth path that makes the Chinese people better off (Lardy 2006). In the short run, this is most likely to lead to a sharp recession, and it will be painful. When investment drops, excess capacity will be evident, and prices will drop. Hundreds of firms will go bankrupt, trade tensions will increase further as failing companies seek to dump product on world markets, and sentiment toward China will swing from positive to negative. A recession of this type is almost inevitable, although we can't say when, if I had to guess, I'd pick 2009, after the Beijing Olympics. But painful as they are, recessions often produce long-run benefits, and that will be the case for China as well. Recession will weed out lots of bad firms, and from this recession we'll see the emergence of the first set of world-class Chinese corporations. After the recession-induced shake-out, Chinese growth will resume, and it will display a long-run pattern very close to the one described above. These shocks, and other crises we have not clearly envisaged, will be difficult and costly. But they should not change our long-run prognosis of China's emergence.

7. "Development is the only Hard Truth"

Out of all the catchy, but perhaps misleading slogans that have filtered out of China in the past thirty years, here's one that's simple but meaningful: Development is the only hard truth. It's a comment by Deng Xiaoping, *fazhan shi ying daoli*.

Because here's the simple truth, China's has developed enormously over the past thirty years. The China skeptics were right to recognize that China experienced a period of luck, when they were lucky to be able to get with growth in a period when the "superstructure," the institutions and human skills, were weak and full of gaps. They were right to warn that an improvised structure of temporary institutions wouldn't be able to stand for long if the foundation of human skills, experience, institutions, entrepreneurship and knowledge weren't there. And they were right, at first, to argue that

the foundation wasn't strong enough, and that therefore the whole edifice was more rickety, more fragile, than might first appear.

But since that time, development has occurred, real development. China has filled in the gaps in human skills, in capabilities, in experience, in rules of the game, and in economic policies. In this case, deep analysis supports first impressions. China today overflows with talent, with newly fostered capabilities. The foundation has grown stronger as the building has grown bigger and taller. Increasingly, it is an adequate foundation on which China will construct the economy of the future. It will be an economy that catches up with the US.

Two simple things follow from this. First, Communist Party power will be challenged. Unlike Wing Woo, I do not believe that the Communist Party will ever construct a harmonious society. Instead, I believe that the growth of independent economic powers, the increasing education and sophistication of the population, and the expanding demands for property rights and personal security will challenge the Party. Powerful interest groups currently grouped within the Communist Party will fragment, struggle over distribution of spoils and protection from losses. At some point, interest groups will stare at each other across a chasm of social chaos, and decide that a real rule of law and political democracy are better than a fight to the death. A truce in the struggle for wealth and power is more likely to lead to political democracy than is a carefully constructed harmonious society. Of course, things could break down, but I think this is by far the most likely outcome.

Second, China still has the capability to adapt to challenges and has far greater depth of skill and resources than before. It is thus on track, although it will encounter substantial turbulence, to keep the economic ship basically upright, as it sails to a qualitatively larger, better and more capable economy. For all these reasons, the US had better get ready. China will be a bigger partner, increasingly asking to be treated as an equal, and increasingly claiming spheres of influence (in Asia, initially) in which it is more than an equal. These changes will require great skills in navigation for the leaders of the US and of China.

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