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### GROWTH CONTINUE?

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CHINA HAS EXPERIENCED the greatest reduction in poverty in the history of mankind: between 400- and 600-million people moved out of poverty, depending on the exact definition used. Its economy grew at nearly 10 percent a year for thirty years, a sixteen-fold increase, which, after allowing for population growth, yielded the country a twelve-fold increase in per capita income. This gave families real choices in life for the first time, not only for themselves but especially for their children. The change has been literally fantastic; if one had forecast in 1980 what China's economy would be like in 2018, both Chinese and foreigners would have dismissed the forecaster as living in a dream world. Yet it happened.

What were the sources of this unexpected growth, and can it continue? This chapter will identify seven sources, and contend that six of them will disappear or be greatly reduced. This means China will see a significant decline in growth during the next decade that, while garnering headlines, should not be interpreted as a policy failure. The slowdown will be for fundamental reasons. Some policies may well fail, but slower growth by itself will not signify failure.

In the jargon of economists, growth requires increased labor supply (including higher levels of education and experience), more capital, and a residual called total factor productivity, which includes everything else. Most studies find that during the post-1978 period,

capital accumulation in China accounted for much of the growth, with increases in labor providing only 10 to 20 percent, implying a significant increase in total factor productivity. But what caused that? I identify seven reasons, and no doubt others could be found.

The first was a significant change of how the government allocated resources. It moved gradually from the top-down, central planning common to socialist systems, which involve government-directed production quotas and extensive rationing of supplies, to a more market-based approach. This meant that both households and companies could make their own consumption and investment decisions on the basis of prices, which, in turn, were strongly influenced by supply and demand, product by product. In addition, domestic prices became more closely linked to those in the world economy.

The second reason was a national shift from near-isolation to engagement with the world economy. Exports were encouraged, initially through tax- and regulation-favored special economic zones (SEZs), later more generally. In contrast to Japan and South Korea, inward foreign direct investment (FDI) was also encouraged, partly through the SEZs, but partly also for the domestic market. This came initially through joint ventures, and later through fully foreign-owned domestic enterprises. The initial goal was to earn scarce foreign exchange and, later, to bring foreign technology (including marketing and management skills) into China.

The third growth factor was exploitation of the extensive overseas Chinese diaspora, whose members were highly knowledgeable about dealing with foreigners and could act as a bridge between the isolated mainland and the rest of the world. Chinese businessmen in other countries knew what goods and services would sell well, especially in the United States and Europe, and were familiar with marketing channels and other technical aspects of carrying on foreign trade successfully. Much of the initial investment in SEZs

came from people in Hong Kong, Taiwan, and other overseas Chinese communities.

The fourth factor was what analysts call a demographic dividend: the ratio of mainland Chinese of working age (15 to 64 years old) to total population rose significantly, from 66 percent in 1990 to 74 percent in 2012. If they could be employed productively—and, in fact, they were—it would augment total economic growth and per capita income. China's one-child policy, of course, contributed to this dramatic "dividend" before serious aging set in.

The fifth factor was a dramatic movement of workers from agriculture into more productive activities. This is a fundamental aspect in all poor countries, which initially are overwhelmingly agricultural, and in which productivity is low except possibly during planting and harvesting seasons. This movement from farms to factories (or service jobs) brought large increases of per-person output. In 1980, 70 percent of China's labor force was in agriculture; by 2016, this had dropped below 30 percent. One important study estimates that this shift alone accounted for 1.1 to 1.3 percent a year in GDP growth.

The sixth factor was an especially high (by international standards) rate of savings and investment—approaching half of the nation's production in some years. Some investment was by state-owned enterprises, and some by local authorities. But much of it came from new entities that were not owned by the central government, such as those started by local towns and villages. These were followed by purely private investments, including some by foreigners, under the new rules that Beijing put into effect. Perhaps 65 percent of total investment came from private sources by 2012, providing buildings and equipment for the rapidly growing non-agricultural labor force. But much of it also provided new and improved housing for a rapidly growing urban labor force with rising incomes. Much also went into infrastructure, partly for such urban needs as water supply, sewers,

roads, lighting, transportation, and partly for ports, airports, and inter-urban transportation such as highways and railroads.

The seventh factor was education. Back in the 1950s, the newly installed Communist Party made the strategic decision to provide free primary education to all young Chinese, bringing a minimum level of literacy to the peasantry. This decision served China well, as more young adults, familiar with the discipline of attending school regularly and following instructions from teachers, moved into regular factory jobs. Free public schooling was extended to nine years from the mid-1980s, and upper-middle (high) schools and universities expanded their enrollment to the point that, by 2016, around 30 percent of young adults were getting some university education, up from only 2 percent in the early 1980s.

These major factors determined China's high growth rate during the three decades following initial economic reform. Of course, advances in technology, mainly acquired from abroad, also played an important role. But new technology largely came from the factors mentioned above: foreign investment (and advice), the contribution of the Chinese diaspora, the high rate of investment, and increased education, including training by foreign firms.

What, then, of the future? Can these seven factors continue to play a significant role? If not, are there plausible substitutes? Unfortunately, the likely answer is negative for all of them except, possibly, education. Let us take them in turn.

China has largely completed the transition to a price-based market economy. There are still some exceptions, especially in banking, petroleum, and telecommunications, so there is still some way to go. But as a source of future growth, further changes in the rules of resource allocation—further economic reforms—are likely to be much more limited than during the 1980s and 1990s.

Foreign direct investment continues to flow into China at a pace second only to the United States. Some modern technology will flow with it, and its future contribution may be similar to the past. But foreign trade, another dimension of globalization, will surely make a more limited future contribution. Chinese exports, measured in dollars, grew by an extraordinary 17 percent annually during the three decades from the 1980s to the 2010s, moving China from a negligible role to the world's largest exporter. Thus, future export growth can no longer give the country a major boost; gains will be more or less comparable to growth of the world economy—perhaps 5 to 7 percent a year in dollar terms (including some inflation). Overseas Chinese continue to be important, but no longer as a major source of growth. Mainlanders have now learned (mostly) how to deal with foreigners directly. That adjustment was a once-and-for-all catch up and has now passed into history.

The demographic dividend ended in 2012, when the ratio of working age to total population reached its peak. It is now projected to decline, slowly at first, then more rapidly in the next decade, returning to the mid-sixties as China's population ages rapidly. The birthrate may pick up now that population policy has shifted to a two-child limit, but aging will be the most important factor. The median age is expected to rise from 35 years in 2010 to 47 years in 2040—an extraordinary rate exceeded only by South Korea. Natality is likely to remain low, as in other East Asian economies, despite the change in policy.

China's agricultural labor force has dropped below 30 percent of the total—still high by standards of industrialized countries. So some contribution to future growth can continue from this source. But the most mobile farm workers have already moved, and the average adult age in the countryside has risen rapidly. Also, land tenure and urban

registration policies (known as the *hukou* system) inhibit families from giving up their agricultural land completely, since they would likely see it reassigned to others. Thus, the continuing movement out of agriculture will likely be less dramatic than in the past, making a lower contribution to growth. In addition, labor productivity in agriculture has risen and will rise further, thus reducing economic gains from this reallocation.

It is a stated policy of recent Chinese governments to “rebalance” the Chinese economy from reliance on exports and investment to greater reliance on private and public consumption—that is, to create a consumer society. In addition, the rate of return on new investment—especially on public investment (infrastructure) and investment by lumbering, state-owned enterprises—has declined during the past decade, implying that even large new investments would make a smaller contribution to growth than in the past. On both counts, therefore, the decline in the rate of investment (relative to GDP) and the decline in the rate of return suggest a smaller contribution to overall growth than in prior years.

Thus, these six factors will do less for future growth than they did in the early post-reform period. These changes are fundamental, not readily influenced by policy, so a decline in China’s future growth should not be called failure. Only the seventh factor, education, may contribute as much as in the past, given the rapid expansion of the educational system—provided the graduates can find good jobs.

The Chinese government, conscious of these slowing factors, has spoken of a “new normal” growth rate of around 7 percent, well below the 9 or 10 percent rate of the recent past. This is an attempt to bring public expectations into line with reality. Thus, the 13th Five-Year Plan (for 2016–2020) assumes average annual growth of 6.5 percent. The government also emphasizes the importance of “innovation” as a key source of future expansion, but it is far too early

to judge how much success it will achieve. The educational system, with its emphasis on rote learning and single correct answers to every question, is not conducive to extensive innovation. China’s level of technology use is below standards of the developed world in many areas and can still benefit from importing more from abroad. But it has been doing so for thirty-five years, and there is no assurance that it can increase its rate of absorbing foreign technology and increase domestic innovation as well.

If it cannot, China can expect its national growth rate—even with no serious policy mistakes—to fall well below the 6.5 percent target set for the next decade, probably to less than 5 percent a decade hence. Yet while such a decrease may bring alarmed headlines, it would not signal a fundamental failure. Both Chinese and foreigners need to understand that.