Will we all have to copy the Chinese?

"The [Eastern economy] is proof that, contrary to what many skeptics had earlier believed a socialist command economy can function and even thrive."

The quote is from the 1989 edition of the hugely successful textbook, *Economics*, by Paul Samuelson. Though, the quote was about the Soviet Union, replace Soviet Union with China and you will echo a sentiment shared by many today.

The Chinese management of the crisis seems to stand in stark contrast to that of the West. Though, the eurozone is in the midst of a recession caused by deep structural imbalances, the European leaders seem unable to present a credible solution. And though the ineptness of European politicians is the current center of attention, we need look back no further than to last summer's American political theatrics around the vote to raise the debt ceiling to find an event that rivals in seeming irresponsibility. Though, the debt level was eventually raised, no serious attempts have been made to address medium term fiscal sustainability. With a Chinese growth rate of an impressive 8 per cent (y/y) in the first quarter of 2012, a rate only slightly lower than the 9 per cent average over the last 30 years, no wonder that the Chinese model is gaining increasing favor.

It is often argued that a political system without cumbersome checks and balances can allow "benevolent autocrats" to efficiently adjust policy to economic reality. Has the Chinese model definitely proven that alternatives to modern market-oriented democracies are possible? Will the ruthless Chinese productivity force all other countries, including those in Europe, to give up their long-cherished standard of living? The answer to both of these questions is a resounding no.

First, as the quote in the beginning illustrates a quick glance at the history books should caution against extrapolating current impressive growth too far into the future. In the decades following the Second World War the question was neither whether a socialist economy can thrive nor whether it would overtake American predominance, but solely a question of when. As the deficiencies of the Soviet economic system became clear the position of challenger-in-chief was awarded to Japan, where a far tighter integration of the financial and industrial sectors was supposedly superior, and later amended with the Southeast Asian growth miracles such as the then authoritarian systems of Korea and Singapore. Though, many prophesies have been made, in 2012 the economies of the United States and the European Union are still much bigger than the Chinese despite much smaller populations.

We can best address the limits of Chinese growth by noting that economic growth as a matter of definition can arise from only two sources: growth in the inputs of labor, capital, land etc, and growth in productivity, that is output per unit of input. It has been recognized since the work of Robert Solow half a century ago that the lion's share of economic growth in developed market economies comes from increases in productivity, which grows at a surprisingly consistent rate of around 2 per cent a year. If productivity in the Soviet Union rose at the same rate, the superiority of the centrally controlled Soviet system's ability to forcibly neglect present consumption in favor of increases in the capital stock should quickly become evident. Though, this is true in theory, there was, however, one problem: there was no productivity growth in the Soviet Union. The lack of free enterprise simply did not encourage the type of innovation that continuously improves productivity in a market economy. As capital accumulation inevitably runs into diminishing returns, whereas productivity gains apparently do not, the economic demise of the Soviet Union was – in hindsight – inevitable.

So what does that teach us about China? First, the similarities. At close to 50 per cent of GDP China has one of the highest investment rates in the world. In fact, the same type of exercise that demonstrated the lacking productivity growth of the Soviet Union, reveals that most of Chinese GDP growth over the last 30 years is a result of increases in inputs. 100s of millions of Chinese workers have moved from subsistence level farming to employment, a process that has been made possible by massive capital accumulation. Though the exact size of the productivity gains is disputed it is doubtful that it is much more than 2.5 per cent a year, and a sizeable share of this probably comes from implementing technology from abroad.[1] Second, the easy gains from increases in inputs have already been earned: There are not 100s of millions of people who can move to cities again, capital accumulation inevitably runs into diminishing returns, and as China seeks to climb the economic latter it will need to move away from producing low-value manufactured items, a task it has yet to prove it can master.

However, contrary to the Soviet Union – and contrary to some popular beliefs – China is not a communist country. Often the economic system is labeled, somewhat unflattering, as crony capitalism: market forces are at play and private enterprise is possible, but property rights are not fully secure and success in business depends strongly on ties with the government officials and bribes, a system that awards political ties and not innovation. In addition the Chinese government is strongly involved in the financial sector and a large share of the allocation of capital is politically motivated. For a couple of years the so-called "ghost towns" –brand new cities entirely vacant – have been a clear sign of the gross misallocation of capital investment. The fact that market forces are at play allows for some innovation and competitive pressure, but history does not find much support for the ability of systems such as these to achieve productivity levels compared with those of Europe and the United States. With current production per capita at around a fifth or a tenth of that of Western European economies (at market values) the Chinese system is very far from having proved its superiority.

It should be noted, however, that the enormous population of China allows it to become the world's biggest economy with a production per capita of a fourth of the US, whereas the Soviet Union with roughly the same population would have had to match the US one for one in production per capita.

To address the second question, it is important to repeat that China is not more *productive* than the Western economies, but due to low wages, long working hours, and a potentially under-valued currency, it is, however, *competitive* in some sectors. But not all: Just like all other countries, China has some sectors of comparative advantage, and just like all other countries it must exploit these. It is a fallacy to think that as China becomes more productive it will outcompete other countries in all sectors, as wages are to a very large extent a result of productivity. As the Chinese economy becomes more productive and the inflow of workers

[1] In "Economic and productivity Growth Decomposition: An Application to Post-reform China", Li and Liu find that increases in productivity (which they label efficiency) is negligible.

from the country side slows down to a trickle, a more productive economy will drive up demand for workers and thereby drive up wages. This is already becoming apparent, and 2011 saw wage increases that far outpaced price inflation throughout the country. If China continues to increase production per worker, wages will continue to rise.

Hence, though far from certain, should China continue to grow, it will not be wages and living standards of Europe that will converge to those of China, but the living standards of the Chinese that will converge to those of Europe, just as has been in the case with other Asian growth miracles. That will be good for the Chinese people and it will be good for us. Nobody in 2012 would wish for Japan, Korea and Singapore never to have developed. There is no reason to think any differently about China.