Why all the worry about China?

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China may not become the world's largest economy after all.

In a paper last October, Harvard economists, Lant Pitchett and Lawrence Summers, took a look at economic history. What they found was that periods of rapid growth didn't tend to last. Per-capita income in the world economy usually grows by around two percent each year. China's rate of eight percent over the past three and a half decades is unprecedented. They took this to mean that the odds of China's growth slowing, possibly sharply, are getting shorter.

In a discussion of their work, The Economist noted, "The surest of historical rules of thumb implies that 20 years from now, China's economy, measured by market exchange rates, will probably still be smaller than America's."

Australian commentators Paul Dibb and John Lee have repeated this. In a paper published in November titled "Why China will not become the dominant power in Asia", they predicted that, "China may soon be approaching the zenith of its power as its economy encounters serious structural impediments and demographic barriers to growth".

If correct, the implication for Australian foreign policy is clear. Forget China, we should be getting closer to the U.S and Japan. Why support the China proposal for an Asia Infrastructure Investment Bank if the U.S and Japan want to stick with the rival Asian Development Bank?

On face value this vigorous writing down of Chinese prospects appears compelling. But take a closer look and it becomes less plausible. In the final analysis, it's a view of China that falls distinctly short.

To start with, no-one is saying that China is guaranteed to grow at the same rate as in the past. The serious forecasters are a long way from being this deluded. They are, in fact, quite realistic. Take the Commonwealth Treasury as an example. In 2013 it released long term projections for international GDP. These put China's average annual growth rate over the period 2020-2030 at 4.3 percent. That's down from eight percent over 2010-2020.

The reason? More investment comes with diminishing returns. That's true in China, and everywhere else.



And yet, cutting to the chase, we can still be reasonably confident that China will have the world's largest economy.

After all, to claim the title it doesn't have that much further to go.

According to the International Monetary Fund, when cost-of-living differences are taken into account, the size of China's economy surpassed that of the U.S last October.

China has also contributed more to global economic growth than the U.S. in every year since 2007.

When measured at market exchange rates, China's economy still sits in second place. In per-capita terms, the gap to the U.S is even larger. But here's the thing: China doesn't need to reach anywhere near U.S levels of per-capita income to become the largest economy. Its population of 1.4 billion means that 23 percent of U.S levels will do just fine. Right now it's at around 15 percent.

It's not those at the coalface who need convincing that China already packs economic clout.

Ask Australian universities whether they think the purchasing power of China's middle class may not be all it's cracked up to be. According to the Department of Education, as of October last year there were 91,386 Chinese students studying at Australian universities. This compares with a grand total of 4,037 from the U.S and Japan.

While there's nothing miraculous about the way China's economy works, don't forget the starting point. Never before has there been a country so poor, with such a large population and so little capital, with such a low rate of urbanisation, and with no private sector or international links to speak of, commit to economic reform.

China's growth will benefit from these initial conditions for some time yet. In 2012, Qu Hongbin, chief China economist at HSBC, estimated that despite extremely high rates of investment, the amount of capital available for each person in China in 2010 was still less than eight percent of that in the U.S. This implies that the problem of diminishing returns to investment is much smaller in China than in OECD countries.

China's economic reform program itself still has a long way to run. Consider its reintegration into the global economy. According to the World Trade Organization, China's share of global goods trade has rocketed to a chart-topping 11.1 percent. But a Bank of England report in 2013 found that capital controls have meant that it holds less than a three percent share of global holdings of overseas assets and liabilities.

To the pessimists, the limited progress China has made in some sectors of the economy serves as evidence that growth will soon stall. To the optimists it appears as growth bursting at the seams, just waiting to be unlocked.

Vested interests make economic reform difficult for leaders in all countries. But Chinese leaders tend to be pragmatic. This was echoed in Deng Xiaoping's famous line - "It doesn't matter if a cat is black or white, so long as it catches mice". None of the reforms that China has implemented since 1979 have come easy. The simple act of allowing non-state owned firms to set up shop in the early 1980s devastated the government's own revenue base as the profits of state-owned enterprises were competed away. Yet according to China-economy specialist Nicholas Lardy, private firms now account for more than two-thirds of total output.

For all the policy and institutional shortcomings that remain, there's a lot that China is doing right. Take a look at what's happening in education. In 2004, China had eight universities in the world's top 500 and none in the top 200. Just a decade on and the respective figures are 32 and six. China's universities are now second only to those in the U.S in terms of research output.

Growth merely slowing in China is not something that Australia needs to fear. Each year China's economy is getting bigger and so growth is coming off a higher base. In terms of the number of dollars being added to the economy – which is what buys Australian iron ore, beef and hotel stays - seven percent growth in 2014 is the equivalent of 10 percent growth in 2010 and 17 percent growth in 2005.

Finally, why all the worry about China? There are grave concerns that OECD economies will not be able to grow at anything like the rates they have done. In fact, the U.S has failed to hit its long run per-capita income growth rate in every year since 2005. In 2014, a paper by eminent macroeconomist Robert Gordon concluded that in the coming decades, per-capita income growth in the U.S will only be 0.9 percent, less than half the long run average. And for the bottom 99 percent of the income distribution, it will be just 0.4 percent.

So where does all this leave us? The balance of informed opinion - and that includes the OECD itself - adheres firmly to the view that sometime before 2030 it will be China that has the world's largest economy.

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