

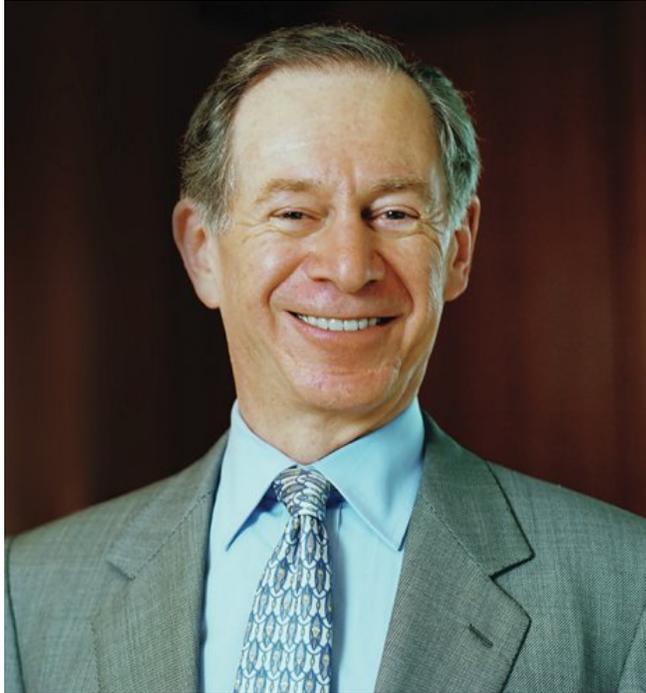
China can continue on path of strong growth

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Productivity still has room for improvement

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**Frank N. Newman Photo: Courtesy of Frank N. Newman**

Many Western commentators believe that the economy of China faces continually slower growth. But China is not a big Western nation. The "new normal" may not be 10 percent annually, but there are substantial reasons to believe that China can continue its strong growth for many years.

Growth in GDP requires growth in both supply and demand. China has done extremely well in helping both to grow, in reasonable balance.

#### Supply

The headline forecasts of single figures for real GDP growth, as often reported by commentators, carry limited information by themselves. It can be very helpful to go just a step deeper, using the basic relationship that shows production (GDP) equal to the number of people in the workforce times the average production per worker.

The percentage rate of growth in GDP is then just slightly larger than the sum of the improvement in productivity per worker and the growth rate in the workforce. So, for example, if productivity (the average amount produced per worker) grows by 6 percent, and the number of workers grows by 1 percent during a year, then GDP will grow at a rate slightly more than 7 percent in that year.

If the combination of growth in productivity and in workforce increases strongly, then GDP can grow strongly - and will, as long as demand keeps up with the supply.

The workforce in China is influenced by key factors in which the government has a major role, starting with maintaining low unemployment, partly by supporting aggregate demand. Other programs include moving millions of unemployed and underemployed people from the rural areas to more productive work in the cities, broadening education, and raising retirement ages. In the US, the rural population comprises 19 percent of the total; in China, 45 percent - and urban employment is growing 3 percent annually. Although the population is aging, China still has large potential for increases in the effective workforce over many years.

The primary challenge for extended growth of an economy is increasing productive capacity. In the very long run, the rate for China will likely come down toward the 2-3 percent that is considered good for developed nations. But labor productivity in China has grown about 7

percent annually over recent years, and fundamental factors can help that continue.

Since the total population is not growing, growth in GDP means continued growth in GDP per capita. But GDP per person in China is still only about 20 percent of that in the US. That leaves tremendous room for growth. If US productivity increases annually by 2 percent, then even an 8 percent rise in China for 25 years would not fully close the gap. China, which has proven its ability to grow effectively, can achieve productivity growth rates well above Western nations for many years.

Productivity improves from innovation and effective management in the production of goods and services. It is influenced by economic investment in technology, equipment, and infrastructure, as well as education and training, labor mobility, and balanced regulation.

Much of this is driven best by a thriving, competitive private sector. The role of government is generally most valuable in providing and supporting qualities that permit the private sector to operate efficiently - such as establishing and maintaining a fair, reliable, and transparent legal system; preventing corruption; maintaining safety and peace; clearing impediments to innovation; improving education; and providing infrastructure.

China has done extremely well in building infrastructure that supports efficient transportation and production. But China has been at it for a relatively short period of time, and can do much more that will add to productivity growth in the future. Premier **Li Keqiang** has noted that China's stock of infrastructure per capita is still well below the figures for the US and Western Europe. The next waves can address a broad range of projects, including clean water supply, environmental cleanup, urban transport, and facilities for education and healthcare.

Much of the thrust of economic reform programs is intended to help resources be allocated more efficiently in the economy, which should result in higher-return investments on average, thus increasing productivity.

A number of steps are underway with the objective of improving the allocation of financing to the most productive activities. Improving credit policies and loan granting procedures, as well as more mature capital markets, will nudge more financing in the direction of the most productive activities. More and higher-quality consumer goods and services will be produced, and more investment will be allocated to their production.

Other key reform programs, including reduction of corruption, and improvements in the legal system, education, and healthcare, should also improve efficiency.

#### Demand

Growth in productivity is critical, but an economy still needs sufficient demand. When demand is stuck in an economy at too low a level relative to capacity, the central government can and should step in to fill the gap.

Monetary policy can help facilitate private-sector demand. China has an exceptional range of tools available to promote increased lending - some not available in most Western countries - including easing of both tight loan-to-deposit ratio limits and administrative limits on loan growth at individual banks.

But more direct forms of spending, especially for economic investment, are essential in many cases. The central government can directly and indirectly initiate and fund substantial amounts of infrastructure investment that can serve two purposes: to provide increased demand and employment, and to improve future productive capacity. China has very successfully supplemented demand of consumers and businesses with an array of programs of economic investment.

Some have viewed increasing focus on "quality of life" as a factor that will reduce growth of GDP; but slower growth does not have to be the path for a better future. Many key objectives can be structured to focus on how GDP grows.

Major programs undertaken to make improvements in the quality of air, water, and food; water distribution; urban transportation, etc. will add to GDP. Local governments can have strongly enforced targets for pollution reduction, in addition to targets for GDP growth. Why greater attention to the environment should not mean slower growth is explained in a recent article by Nobel laureate Michael Spence: Growth in the New Climate Economy.

Growth of the consumer sector is a reform objective that will take time, but programs to increase the after-tax income of workers - through higher incomes and lower taxes for workers and consumers - combined with improved retirement and health plans, should lead to substantial increases in consumer spending.

In the US, China, and other large advanced economies with their own currencies and central banks, the central government can always finance infrastructure projects, directly or indirectly. Other than China, however, few nations have supported demand on the scale needed to close the gap between actual demand and the level for full employment and use of growing supply that serves genuine demand.

The potential for adding to aggregate demand in both the US and China is huge. In the US, engineers estimate that about \$2 trillion is needed just to repair and maintain the existing infrastructure; plus there is great need for investment to improve and modernize it.

#### Investment benefits

Concern is often voiced that some investment projects in China have been inefficient or unsuccessful. That is valid, but exaggerated; some imperfection is natural in any economy, including in the private sector. Increasing attention in China on better investment decisions, including through better use of market forces, should help improve the overall results.

For poor investments already made, the real economic costs have already been incurred. The issues are who will take the financial losses, and how. China has numerous ways to deal with those questions, without significant disruption of the system.

Investment can add substantially to an economy even if some projects are unwise. In the US, demand has been well below capacity while millions of people went unemployed. That was real waste of resources which should have been used productively. While some resources in China's big programs of 2009-10 were misallocated, China had much lower unemployment, and has much improved infrastructure, while the US has deteriorating infrastructure.

This does not mean that thoughtless or corrupt projects should be accepted. Wise spending on infrastructure is clearly the objective, and many of the reforms in China are intended to improve the decision process, thus resulting in higher growth in productivity, larger real GDP, and improved real quality of life for its people.

#### The financial system

In addition to reforms to improve the allocation of financial and real resources in the economy, two other aspects of the financial system are critical: the capacity to finance investment and build demand, and the ability to avoid or limit interruptions to economic activity from financial crises.

Many countries have feared large scale programs of economic investment for reasons based on misunderstanding of government finance in nations with their own currencies and central banks. My book, *Freedom from National Debt*, explains why fears of runaway interest rates and inflation, failed markets, and high taxes are all unfounded. Government securities do not represent a great burden to future generations: taxes are never required to pay them off in aggregate. Securities issued by the US and China cannot face the problems of those issued by eurozone nations. They do not increase or decrease the money supply, and do not crowd-out funds available for investment. Both China and the US can finance all the steps needed to create jobs, repair and improve infrastructure, lower taxes, and prevent financial crises.

There are real credit risks in China, of course, but this concern is often exaggerated. Some local government entities face financial challenges, and need reform; some buildings are not fully occupied; some wealth management products, as well as other aspects of "shadow banking," will present problems. But those risks should be kept in perspective. Banks in China are generally well capitalized by new international standards, and are raising more capital. Deposit reserves are very high, and nonperforming loan (NPL) ratios are low. Concerns that NPLs are larger than they appear are widely reported; less well publicized is that, at the direction of the regulator, banks have already established provisions sufficient for more than twice the current level. Chinese banks are significantly better prepared than many Western banks for potential increases in NPLs.

Most importantly, China understands that financial crises have severe effects on the real economy, and strong steps can and should be taken to deal with any substantial emerging financial-system problems. The bank cleanup at the start of the century provides a good illustration of what works. Purchases of problem assets freed major banks from the burdens of problem loans and established a base to serve the needs of a rapidly growing economy. While such a major program should not be necessary in the future, smaller targeted versions could be used any time the government deems appropriate.

The biggest risk for China would come from adopting too much prevalent Western financial doctrine, which could needlessly limit policy options. There will be no serious risk of financial crisis as long as the central government continues to handle key problems actively.