# China's True Growth: No Myth or Miracle

*by Jonathan Anderson*

IF YOU WANT to know what the world thinks about China's economy, best keep track of what the typical international corporate executive is reading. For the past year or two he has been reading some very provocative books about the mainland business climate. Four in particular top the current "best-seller" list: *The China Dream* by Joe Studwell (second edition reissue), *Mr. China* by Tim Clissold, *China Inc.* by Ted Fishman and *China Shakes the World* by James Kynge. All four are aimed at the mass market and are very entertaining, but they also have significant things to say about the broad economy: how it works, why it works and what's driving growth.

Anyone deciding to read all four volumes, however, would come away bewildered and confused. Messrs. Studwell and Clissold essentially portray China as a house of sand, presaging the downfall of a bubble economy that has propped itself up through a potent cocktail of free capital and distorted resource allocation. Meanwhile, Messrs. Fishman and Kynge show an unprecedented, world-beating dragon, a success story that is changing the world in myriad ways.

How to explain the difference? It helps to remember the timing. The first two books deal with the events of the mid- to late-1990s, when China was reeling from a sharp economic slowdown: profits were collapsing, the government was putting millions of state workers out of jobs, and cynicism was widespread. The other two are focused on recent trends, essentially written at the top of the cycle: enormous growth, a massive export boom and seemingly unstoppable momentum.

There is, however, one overarching theme that comes screaming through in all four books—and indeed, from almost everything we read today: Whether success or failure, boom or bust, China is the story. Completely *sui generis* in scale and scope, different from everything that came before, the most dramatic event of the century, China "matters" in a way that no other emerging market has.

But what if this turned out not to be

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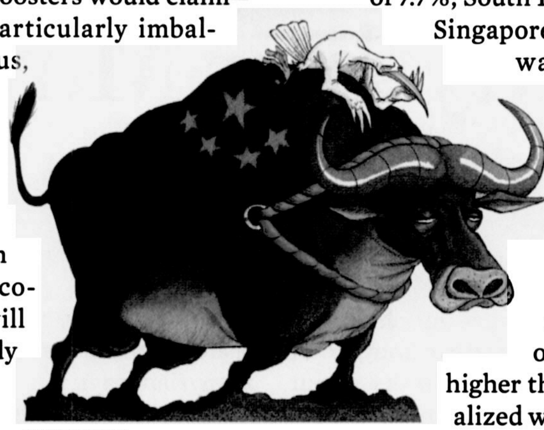
*Mr. Anderson is chief Asian economist at* UBS.

true? What if China were, in fact, little different from its neighboring countries, in terms of size, speed and importance? In short, what if China were boring?

This is not a rhetorical question, because from a macroeconomic point of view China's growth dynamic is nowhere close to the unprecedented, world-changing phenomenon that boosters would claim—nor does it look particularly imbalanced or precarious, as the naysayers would have it. In fact, looking back 50 years from now the mainland will probably not be seen as special at all; economic historians will place China as a fairly regular part of a growth chain that began with Japan, filtered down through the Asian tigers and subsequently passed on to the Indian subcontinent.



HARRY HARRISON

If this sounds strange, it shouldn't. But then, most of us have probably forgotten what the world felt like a few decades ago when the original Asian growth boom was still in full swing. And many observers, if not most, lack the formal economic background required to dissect the regional growth story and determine what really makes it tick. So before we think about China, or India, we need to step back and revisit the experience of their neighbors.

## An Asian Digression

IT'S SAFE TO say that the world had never seen anything even close to the growth statistics coming out of Asia in the second half of the 20th century. Between 1950 and 1980, Japan grew at an average real rate of nearly 8%, more than twice the pace of its industrialized counterparts over the same period. In fact, in inflation-adjusted U.S. dollar terms the economy was doubling every six or seven years, an astounding feat by any standard. And this was just the beginning. A few years later an even faster-growing Asian contingent appeared on the scene: From 1960-95, the Hong Kong economy grew at an annualized real pace of 7.7%, South Korea grew at 8.1%, Singapore at 8.4% and Taiwan at a stunning 8.6%. In Southeast Asia, "quasi-tigers" like Thailand and Malaysia were not far behind.

These growth rates were not only orders of magnitude higher than in the industrialized world, but also much faster than most other developing economies. By the 1980s, with the world's richer countries in recession and Asia still growing at a near-record pace, the questions began to mount. Had Asia discovered something that the rest of the world had missed? A new way to organize economic activity? In short, was Asia a miracle?

Suddenly, the "Asian growth model" appeared in business-school lecture halls, in academic conferences, and most of all in the popular press, where titles like *Japan as Number One* and *Rising Sun* ruled the day. What was the actual model? On this point most observers differed, but there was a general feeling that whatever Asia was doing, it was somehow better than the atomistic, consumer-driven *laissez-faire* economic culture of the Western democracies. Tight-knit corporations were not beholden to outside shareholders and thus achieved better industrial performance. Traditional Asian values and social cohesion made for a more optimal climate than

> *What if China were little different from its neighbors? In short, what if China were boring?*

the competitive "me-first" Western model. The main worry was that Asia was consistently outperforming all of its neighbors, and that even in the long term the rest of the world would not be able to keep up.

There were detractors, of course, and for the most part they skewed to the other extreme. Not only was high growth not a miracle, but Asian countries basically got to where they were by cheating. Companies were force-fed cheap capital by state-led banks. Foreigners were not allowed to compete. Exchange rates were hugely undervalued, providing an unfair cost advantage. Governments were mercantilist, suppressing imports and running large surpluses to fund growth. The result may have been resource misallocation on a massive scale, but it didn't matter as long as U.S. and European consumers were willing to buy up all their products.

It wasn't until the early 1990s that economists got around to looking at these stories using formal economic tools. What they found blew away both views—and also established one of the most famous findings in modern international economics.

They started with the traditional growth model found in almost every college economics textbook. Stripped of extraneous bells and whistles, the basic formulation offers precisely three ways for an economy to expand: Add more labor, invest more capital, or combine labor and capital in new and better ways, which allows for more growth at every level of physical input. This last element is productivity, or using the proper terminology, "total factor productivity" growth.

Thinking about growth in this way provides a surprisingly easy test of the "Asian model." If Asia really did create a miracle, in the sense of a fundamentally new way of doing things, then a large share of the region's 8%-plus real growth rates would be attributed to total factor productivity expansion. If, on the other hand, governments were forcing superheated growth through heavy-handed, distortive policies, then TFP growth would be negative, a sign that Asia was actually destroying value over time.

Economists had been measuring growth in individual countries for a long time, but with 30 years of statistical data behind them, researchers finally had a chance to test the "Asian growth model" hypothesis across the entire region. One of the first, and the most famous, to do a systematic study of the Asian tiger economies was Alwyn Young. In a series of papers in the early 1990s, he reached two very interesting conclusions.

First, the average rate of total factor productivity growth was decidedly ... well, average. From a productivity perspective, Asia looked exactly the same as the U.S. or EU, with TFP contributing around 1.5 percentage points to total annual growth. Some countries in the region did worse, and some did better, but the overall conclusion was clear: Asia had not discovered a wonderful new growth formula, nor was it any less productive than the developed West. So much for the Asian "miracle." And so much for Asian "cheating."

But if productivity wasn't the main differentiating factor, what did explain the growth gap between Asia and the rest of the world? This was Mr. Young's second major finding: As it turns out, almost all of Asia's growth outperformance was due to its extremely high rate of capital creation, more than three times faster than in the U.S. or the EU. Simply put, Asia grew faster because it invested more, full stop.

As you can well imagine, this was a highly controversial conclusion. Instead of finding world-beating new ways to produce, it turns out that Asia's main advantage lay in putting large amounts of capital on the ground (and, to be sure, in finding underemployed rural workers to populate the factories). In Paul Krugman's famous phrase, the region's success came from "perspiration, not inspiration".

Now for the most important question: How did Asia manage to generate so much more investment? And so uniformly across countries? After all, the region was a relatively diverse place: large countries, small city-states, some rich, some poor. Japan and Korea depended heavily on state-led banks and repressive financial polices to channel savings into productive investment. Taiwan and Hong Kong had more liberal economic environments. Political arrangements varied enormously. Yet everyone managed to grow at virtually identical rates.

The answer is that Asia invested more because it saved more. In fact, with the possible exception of a common focus on export markets, a high domestic savings rate was the only common element that tied all the fast-growing Asian economies together. Just look at the chart nearby, which shows historical savings and investment ratios for Japan and the Asian "tigers" compared to the United States.

From 1965-95, the U.S. gross domestic savings rate averaged 18% of GDP, and the U.S. economy invested 17% of GDP over the same period. In high-growth Asia, meanwhile, the average domestic saving ratio was an astonishing 32%—and as a result Asia was able to generate sustainable investment rates of 31%, nearly twice as high as in the developed West.

The bottom line finding was an extremely powerful one. Institutions, organizational models, specific ways of doing business, none of these mattered very much at the end of the day. What did matter is savings, and the lesson of Asia is that when you have domestic savings rates of 30% of GDP or more, it's awfully hard not to grow at 8%.

## And So to China

TURNING TO CHINA, the reason for our long detour should be immediately apparent. Over the past 25 years, the mainland economy recorded an average real growth rate of more than 9.5% per annum, making it the new world record holder among major economies. Does this make China different? Are there unique factors that push the mainland to the head of the pack? Or is this just one more example of an Asian high-growth economy in action?

Most casual observers would respond that China is very different indeed—but the broad bulk of serious research on the mainland economy says they're wrong. Despite China's seemingly world-beating rise and the hype surrounding China's "special circumstances," from a macroeconomic perspective the mainland looks almost exactly like its Asian predecessors.

We know this because over the past 10 years analysts have applied the same decomposition tools to Chinese growth as they did to the rest of Asia. Even if we bring those headline numbers down a notch (most economists assume an average growth rate of perhaps 8.5% to 9% over the past few decades), the Chinese growth story is hauntingly familiar to anyone studying the earlier Asian experience: a reasonable but respectable TFP role, another modest share coming from labor force growth, and an overwhelming contribution from capital investment. As it turns out, the only reason mainland growth has exceeded the rest of Asia is because China saves and invests even more than its neighbors, as you can see from the chart.

Meanwhile, many of the "China specifics" that investors invariably cite turn out to be common Asian characteristics as well. An artificially low cost of capital? Nothing could be further from the truth. Low interest rates are a classic economic result of Asia's high gross domestic savings rate of 35% to 40% of GDP, especially when you consider that these funds are invariably funneled through overdeveloped banking systems across the region. Chinese real interest rates may look very low by historical emerging market standards, but not by Asian standards; in fact, average rates in China are no different from the four Asian tigers over the past few decades—and much higher than in Japan during its high-growth phase.

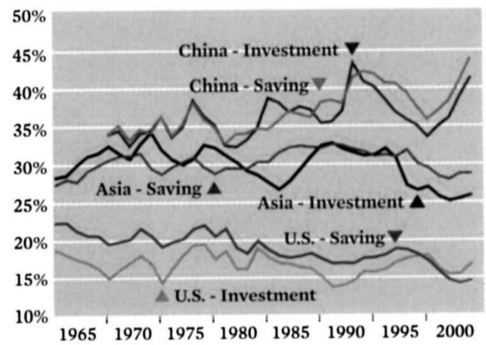
An undervalued yuan? Current account and balance of payments surpluses are yet another natural corollary to high domestic saving rates. Asian countries don't import capital; they export it, and this makes their exchange rates look chronically undervalued even under the best of circumstances. Even China's recent cyclically high current account surpluses are well below the historical peak surpluses in Korea, Taiwan, Hong Kong and Singapore as a share of GDP. And anyone involved with international economics in the 1980s would find today's preoccupation with the level of the yuan eerily similar to the widespread obsession with the yen, the won and the Taiwanese dollar back then.

What about China's planned economy? Surely this is one crucial difference between the mainland and the rest of Asia, as China's socialist, state-led model uniquely forces excessive amounts of capital into unproductive activities, with high growth rates but low social benefit?

Not according to the numbers. Nearly every academic study shows that the TFP contribution to overall growth in China has been slightly higher than the Asian average, which means that China actually has a better productivity record than its neighbors. In part, this is a reflection of the rapidly growing private sector; the state accounted for more than two-thirds of the economy 15 years ago, but only one-third today. And in part, it reflects the mainland government's surprising commitment to some core market principles.

**CHINA OUTDOES ASIA AND U.S.**

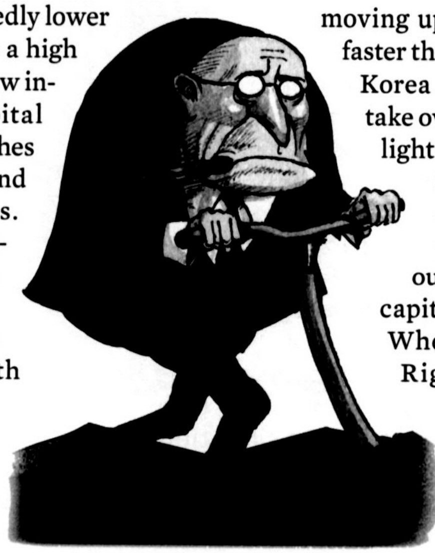
*China invests and saves even more than other Asian nations and U.S., in share of GDP.*




SOURCE: UBS; ASIA= JAPAN AND ASIAN TIGERS

Japan and Korea, in particular, have a long history of placing social cohesion above economic rationalization (think of Japanese "zombie" companies in the post-bubble 1990s)—but not China, which when faced with its own sharp downturn in the late 1990s immediately set about shutting down tens of thousands of insolvent firms and making nearly 30 million state workers redundant. Both Japan and Korea also actively discouraged excessive foreign competition throughout their development history—but not China, which last year alone attracted more foreign direct investment than Japan did over the entire last decade.

How can this be, when Chinese companies are notorious for not making money? The answer is that this is an outright myth—Chinese companies do make money, and a good bit of it, over the typical business cycle. What is true is that China's return on capital is relatively low, but this also turns out to be a fairly mundane problem in high-savings Asian economies. If you look at data on corporate return on equity or return on invested capital across Asia for the past 10 to 20 years, you will find that the best corporate performers are invariably in low-savings countries like India and Indonesia, while Japan and the Asian tigers have markedly lower returns. Why? Because a high pool of savings means low interest rates and capital costs, which in turn pushes up investment rates and drives down returns. When we compare China to the neighbors, its average rate of return is virtually identical to the rest of high-growth Asia.



## Size Matters

BUT DOESN'T THIS miss the point completely? After all, the most striking fact about China is not its growth potential, but rather its size; with 1.3 billion people, surely the mainland has a much bigger impact on the global economy than the earlier Asian growth leaders? The answer is that of course China is bigger—but so is the rest of the world. Even when we account for absolute size, we still find that the mainland's dramatic rise has no more of an impact on the developed world than that of its neighbors a few decades ago.

Here are the numbers: From only 4% of global output in 2000, China should account for 11% of world GDP by 2025. Impressive, certainly, but compare this path with Asia's historical performance: In 1965, Japan, the Asian tigers and Asean collectively accounted for exactly 4% of global GDP; 20 years later, in 1985, the share had increased to 13%, and more than 16% by 1990.

On the trade front as well, China's forecasted rise to 12% by 2025 from 4% of global trade looks little different from the historical performance of its Asian neighbors, which increased their share to 15% by 1990 from 6% in 1960.

How about competitiveness? Is China moving up the value-added chain faster than the rest of Asia? It took Korea and Taiwan 10 years to take over global market share in light manufacturing, another 10 years to develop its electronics industry, and a third decade to switch out of low-end exports into capital-intensive industries. Where does China fit in? Right on schedule. The mainland spent 10 years from 1990 until 2000 taking over low-end markets, and for the last five years has been rapidly gaining market share in electronics.

The bottom line is that China's growth trend is impressive, but by no means unprecedented. Quite the opposite: Whether we look at GDP, trade or industrialization, the mainland has been treading a path laid out earlier by other Asian economies—and is, at best, simply matching the dynamism of Japan and the Asian tiger economies. Obviously the world faces challenges from a rising China, but it has faced these before.

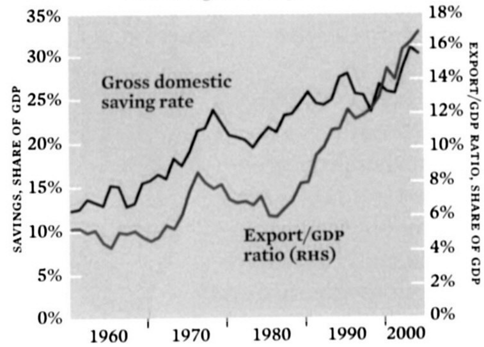
## India, the "Stealth" Tiger

AND IT DOESN'T end with China. If the mainland economy is simply the latest in a long chain of Asian success stories, then it makes sense to assume that more are on the way. In terms of the broad macroeconomic factors above, it's hard to avoid the conclusion that India will soon be joining the fray.

This may sound incredibly optimistic to anyone who's ever been to India, where the economy is, if anything, seen as the "anti-China": highly politicized, fraught with a dysfunctional bureaucracy, overly regulated in every area and fragmented in the extreme. The physical infrastructure is in sorry shape. Economic indicators don't seem very promising: The budget is in large and chronic deficit, the balance of payments is prone to fragility, and capital costs are significantly higher than in East Asia. In this light, the recent IT services boom looks like a small oasis in a sea of troubles. India has never been able to generate any dynamism in the manufacturing sector, and receives less than one-tenth of the FDI inflows that China does.

**INDIA PLAYS CATCH UP**

*India's savings rate is on the up while exports take on a greater importance.*



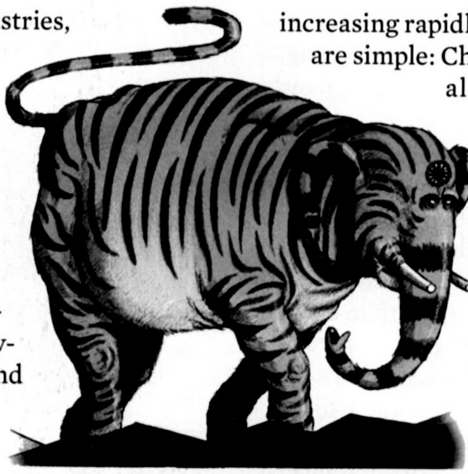

SOURCE: UBS

But keep your eye on the macroeconomic fundamentals. As we saw above, what really matters is savings, savings and more savings. How does India fare? Twenty years ago, the gross domestic savings rate was well under 20% of GDP, more a Latin American-style laggard than an Asian tiger, and as a result Indian real GDP growth was idling at around 4.5% per annum. However, as the chart nearby shows, over the past decade India's savings ratio has risen to nearly 30% of GDP, and the trend is still strongly upward. Suddenly the economy is generating 7% real growth or higher—and no longer looks that much different from its East Asian counterparts.

Where will the savings go? Eventually, into export manufacturing. Unlike China, India still has a rapidly growing population, and again unlike China, India has had a difficult time raising agricultural yields and productivity—it does not have anything remotely close to China's equitable land distribution. This makes it imperative to achieve rapid employment growth outside the rural economy, and despite the celebrated success of the Indian services sector, services are simply not capable of generating hundreds of millions of new jobs. Looking at the Chinese and Asian experience, labor-intensive export manufacturing has always been a key destination for savings and the strong initial driver of new income growth.

This hardly seems like a reasonable expectation for India. But remember that when China was starting out in the late 1980s, it looked far worse than India does today. The state accounted for most employment in the nonagricultural economy, and labor restrictions were very onerous. There were very few truly private firms, and private capital had no legal protections whatsoever. Inflows of FDI were a paltry $2 billion per year, much less than in India currently. On paper, the economy was almost completely closed, and the authorities had only a tenuous interest in market-led reforms.

Moreover, when China's export economy began to develop, it was not led by central policy decisions, nor was it due to the formal easing of economic controls or restrictions. And it didn't happen nationwide; instead, it happened in one province, Guangdong. In order to take advantage of cheaper labor, Hong Kong manufacturers gradually began opening factories over the border. In order to create jobs, local authorities were more than willing to ignore formal restrictions and provide incentives on the ground. Because of the labor-intensive nature of the industries, the initial dollar amounts of investment were relatively small.



It wasn't until a half-decade later, when other provinces started to replicate Guangdong's successes, that the central government took notice and undertook a more fundamental liberalization of the economy, allowing greater leeway for FDI and export manufacturing on a nationwide basis.

And the most interesting thing in this regard is that from the chart on the previous page, India now looks almost exactly like China did in the early 1990s, with an export-to-GDP ratio of around 15%—and increasing rapidly. The lessons for India are simple: China isn't a dysfunctional outlier. High Indian savings rates are already in place. And it doesn't necessarily take a revolution to get the export story going, sometimes all it takes is a little push.

We even have a likely candidate for that push, as rising mainland unskilled wages are already starting to put pressure on low-end export industries. And as China's costs go up, India could start to look attractive indeed. So keep an eye on the Indian export sector over the next five years—this just might be the catalyst that finally launches the country's career as a tiger. ■