Wealth of Nations

Why China Grows So Fast

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Sustained high growth in developing economies is a recent, post-World War II phenomenon. Using GDP figures, I take "high" to mean above 7% and "sustained" to mean over 25 years or more. These cutoffs are arbitrary, but a similar picture emerges with variants. Growth at these rates produces very substantial changes in incomes and wealth: Income doubles every decade at 7%.

There are 11 such cases of sustained high growth, and eight are in Asia. These are Botswana, China, Hong Kong, Indonesia, Korea, Malaysia, Malta, Oman, Singapore, Taiwan and Thailand. Per capita income data are somewhat lower because of population growth. China is the latest case, the largest in terms of population, and the fastest. India is entering a period of high growth. While it remains to be seen whether it will be sustained and for how long, the essential ingredients are being put in place, and the general sense of optimism seems justified.

Growth at these rates is clearly possible, as the cases show. But they should not necessarily be taken as targets or goals. We have no evidence yet that *all* countries can achieve growth at these rates, even ones at similar stages of development as measured by income levels. What is clear is that meaningfully high growth rates that significantly improve peoples' lives and their freedom to be creative are increasingly accessible, and that understanding how they are achieved is of great value to the governments and the leaders of developing countries, as well as to advanced countries, international institutions and NGOs that seek to be supportive.

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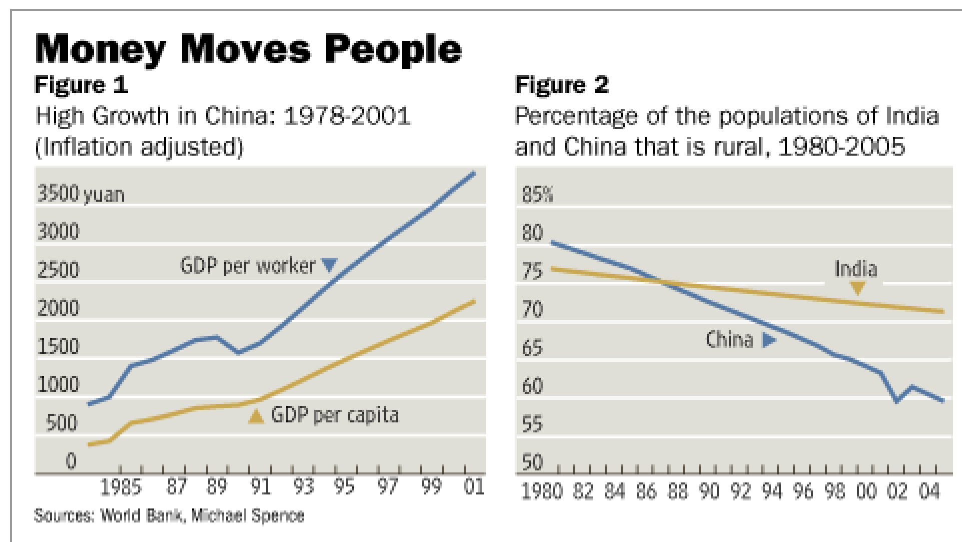
Growth in incomes comes from three sources: (1) investment, (2) technology or applied practical knowledge, and (3) increases in the fraction of the population that is productively employed. The last is important in the early stages of growth, because drawing labor from traditional sectors, where it is in surplus, to new, more productive employment, is an important driving force.



While each instance of sustained high growth is to some extent idiosyncratic, they share certain features. In all cases, there is a functioning market economy with its price signals, incentives, decentralization and enough definition of private property ownership to enable investment. All attempts to circumvent this necessary condition through central planning have met with major misallocations of resources and failure.

The high growth paths are characterized by high levels of savings and investment, even in the early stages when the per capita incomes were low. "High" savings in this context means at or above 25% of GDP. China again was the high-water mark ranging between 35% and 45% of GDP. The investment includes a substantial component of public-sector investment in education and infrastructure, both being crucial as they increase the rate of return to private-sector investment, which is the proximate driving force in the growth process.

A third key ingredient is resource mobility. Contrary to the image that sometimes comes from a macroeconomic overview, productivity growth at these rates is not achieved by having everyone do what they were doing before, but a little bit more efficiently. The portfolio mix of economic activity changes very rapidly. This is what Schumpeter called "creative destruction" and Paul Romer calls "churn."

At company and industry levels, new firms and sectors are created and others decline or die off. If you take a snapshot of a rapidly growing developing economy at five-year intervals, the changes are dramatic. At 15-year intervals the same economy is barely recognizable in the second picture. South Korea is not now a center of labor-intensive manufacturing, but it once was. The same is true of Japan, though one needs to be in an older generation to remember. Even advanced economies like Spain, Ireland and Italy were at some stage surplus-labor economies, and employed that in labor-intensive industries, or exported it, or both.

In the early stages of rapid growth, the agricultural sector is usually the location of a vast majority of the people. Typically, labor is underemployed in these traditional sectors. People move to cities and new industrial sectors where investment is taking place and productivity is higher. The loss in output in the traditional sector is minimal or zero because of the surplus labor condition, and hence the overall productivity gain is substantial. Figure 2, above, shows the percentage of the population that is rural in India and China. This movement of people geographically and across sectors is not an ancillary side effect of the growth process, but rather the essence of it.

The difference between the growth rate of GDP per capita and GDP per worker in China (Figure 1) is very close to the 1% per annum decline in the rural population: the movement of people to high growth and high productivity sectors that serve global economy demand. It is worth noting that this movement of people is a major challenge in the development process. In the case of China, 1% represents 13 million people who are essentially moving to cities each year, with attendant needs for infrastructure, education and services.

As people move and productivity rises, it is possible for everyone to be better off. But those who move to new sectors first have higher productivity and higher incomes. The result is a pronounced tendency for income inequality to rise, and for an extended period. While this is a natural consequence of the process, it presents a challenge. Excessive inequality of income and wealth is not only a normative problem in most societies; it is also socially and politically disruptive and can threaten the support for the policies and public sector investments that in part sustain the growth process. As a result it needs to be mitigated through the redistribution of income or other important services such as health care, education and pensions, and by ensuring that access to infrastructure (clean water, transportation, power) is reasonably equitable.

Institutions and policies that retard the movement of people and resources will also retard growth, a fact that is true in advanced as well as developing economies. Such policies may nevertheless be justified on the ground of protecting people from the full effect of market forces. But such protections are best if they are transitory and not permanent, and generally it is better to protect

people and incomes rather than jobs and firms. The latter approach impedes the competitive responses of firms in the private sector and, in the context of the global economy, becomes very expensive.

Probably the most important feature of sustained high growth is that it involves leveraging the demand and resources of the global economy. There are no known exceptions to this principle. All cases of sustained high growth prominently include a growing export sector as a growth driver and a rising fraction of GDP associated with exports and imports. There are no examples of sustained high growth in the postwar period that do not involve integration into the global economy. The systematic reduction of barriers to trade and investment in the last 55 years, and the dramatically falling costs of transportation and information and communications technologies, have combined to raise the level of that integration. It is the combined effect of these trends that has made the global economy an increasingly powerful source of potential growth.

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