

# **The Chinese Economy: Past and Future**

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# Key Development Facts

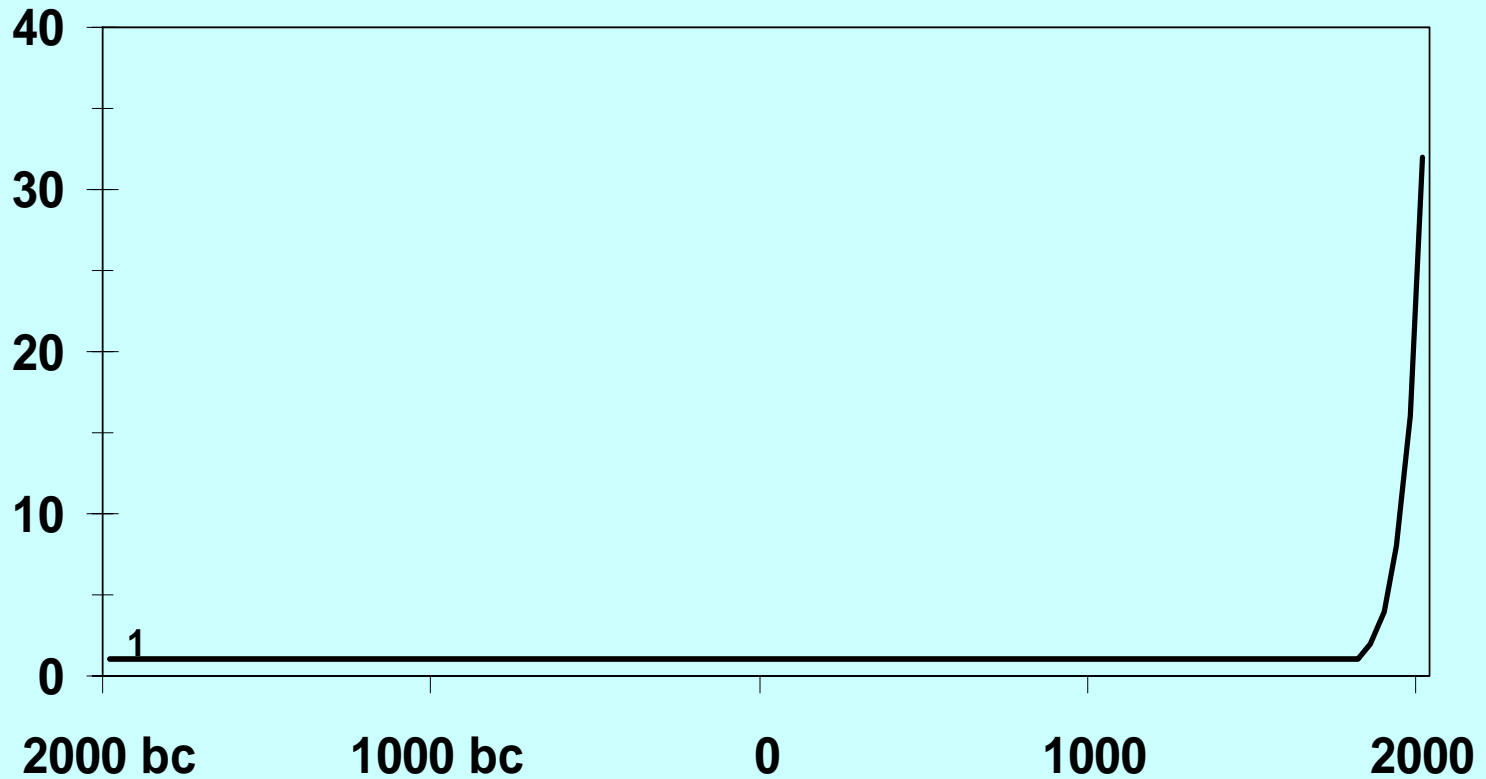
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- ❖ Prior to 1700, constant living standard varied little across countries and over time.
- ❖ After 1700, living standards began to increase in some countries.
- ❖ After 1850, they doubled every 35 years – *modern economic growth*.



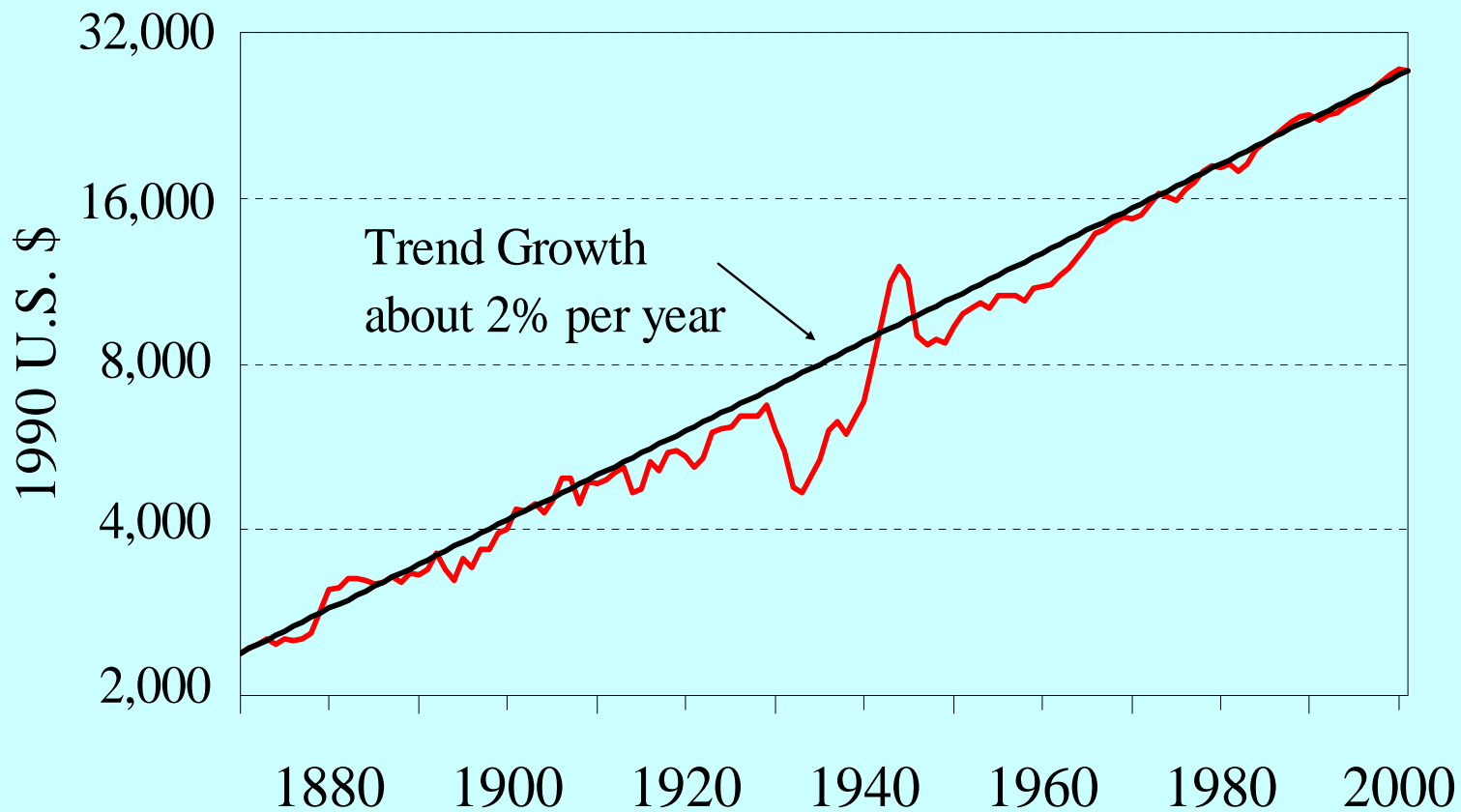
# Explosive Growth Post-1800

Leader's Per Capita GDP  
Relative to Pre-1800 Level





# U.S. Per Capita GDP



Source: Maddison



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- ❖ England entered modern growth first, U.S. and Western Europe a little later.
  - ❖ China entered much later (post-1950).
  - ❖ As a result, China is not now among rich nations.
  - ❖ Some late starters have caught up.
  - ❖ China has been catching up.



# China Leader in Song Dynasty 960 - 1279

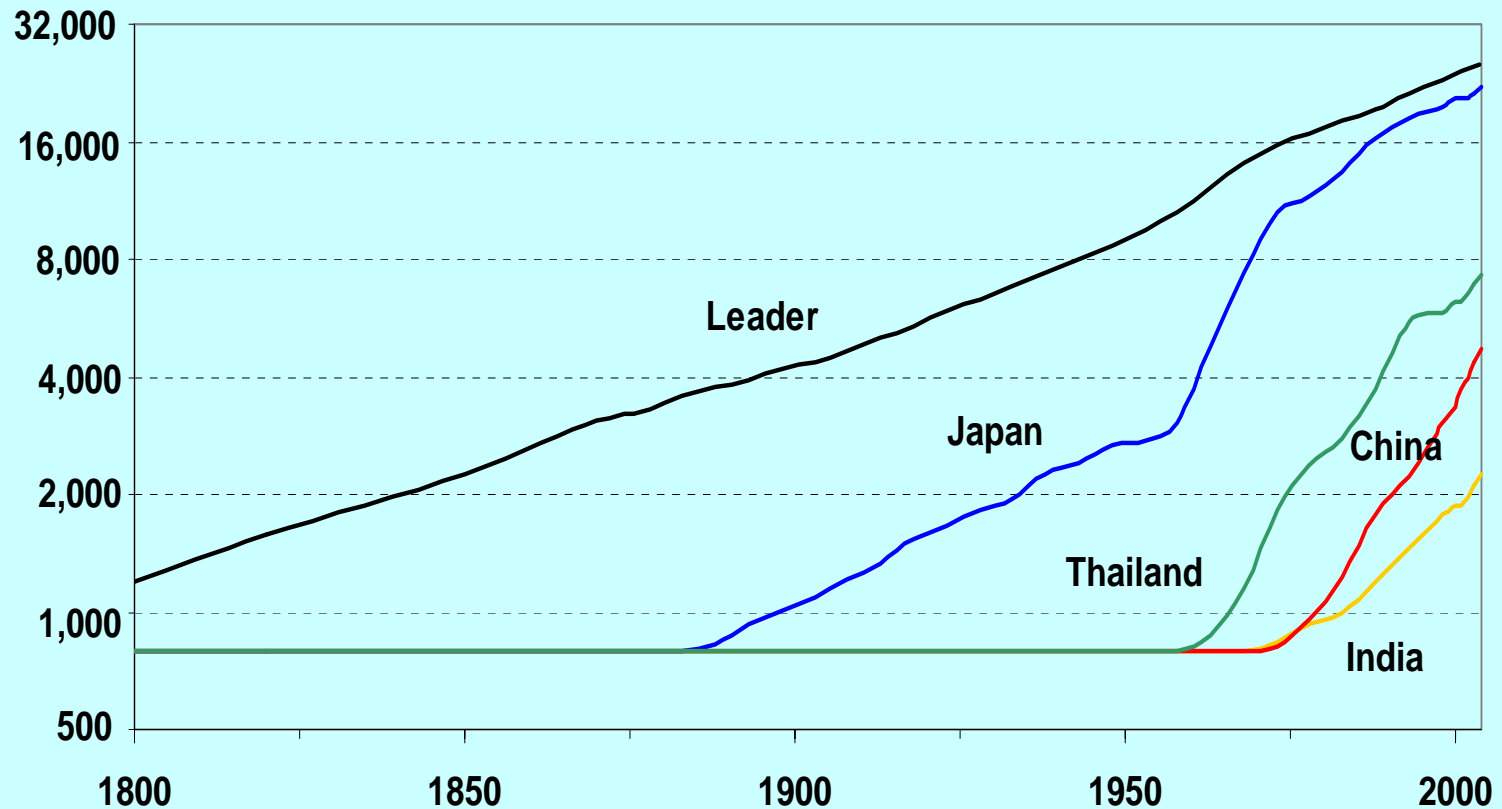
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- ❖ Doubled population and per capita income.
- ❖ High rate of technical innovation.
- ❖ Technical regression set in with the Ming and Qing Dynasties (1368 – 1911).



# Different Countries Start at Different Times

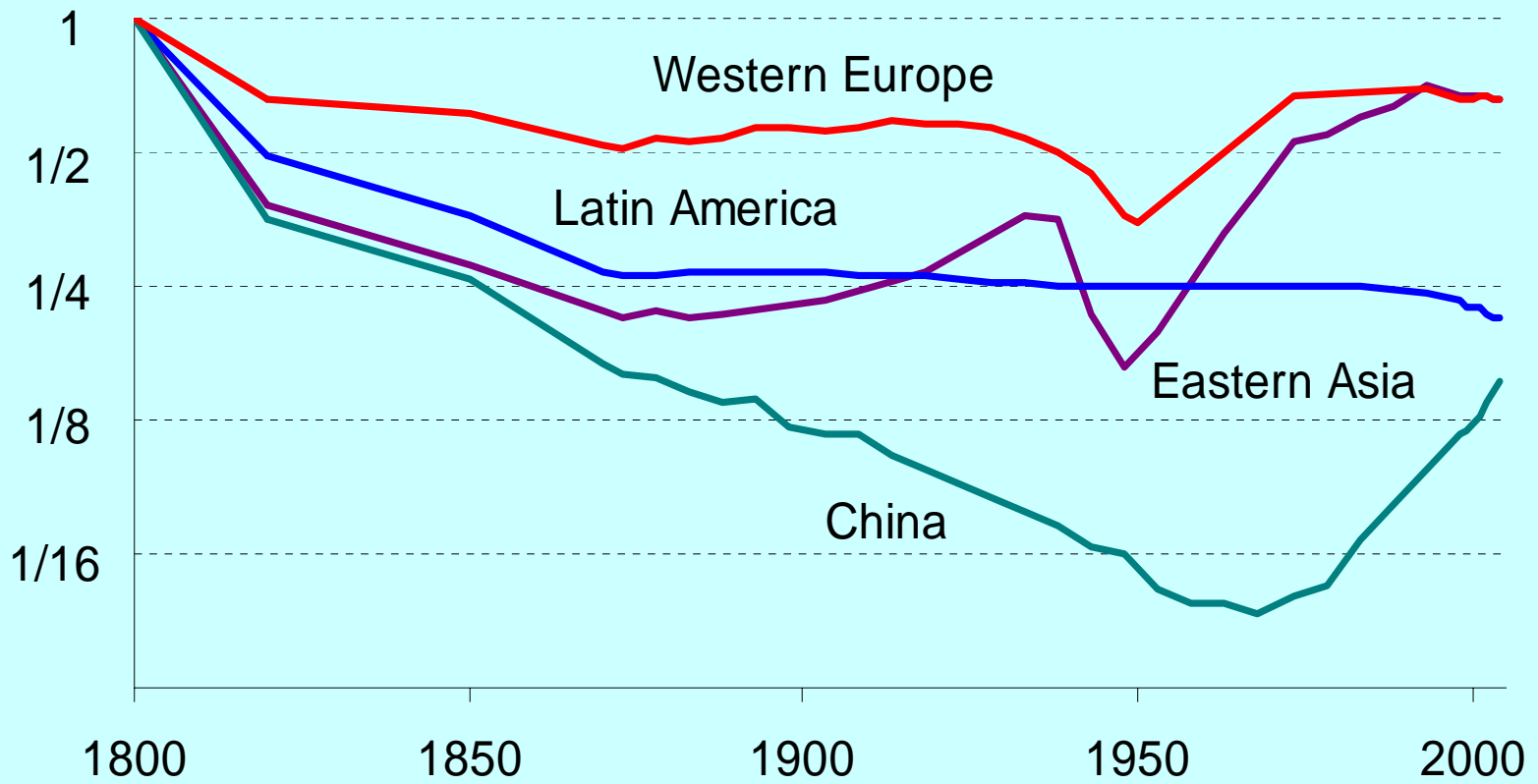
## Per Capita GDP Trends (1990 U.S. \$)





# Regional Growth Patterns

Income: Fraction of the Leader, 1800-2004







# Theory of Pre-1700 Period

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- ❖ Land crucial to production. Trade-off between living standards and population size.
- ❖ Increases in stock of useable knowledge lead to increase in output. But, this is offset by population increase.



# Theory of Post-1850 Period

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- ❖ No trade-off between increases in living standards and population size.
- ❖ Increases in stock of useable knowledge lead directly to increases in living standards.
- ❖ Key feature is the use of fossil fuels for energy rather than land.



# Problem with Theory

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- ❖ Why didn't all countries start modern economic growth at the same time?
- ❖ Parente and Prescott's theory: A society's productivity also depends on the set of constraints it imposes on its businesses.



# Why Constraints Exist

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- ❖ Constraints exist to protect industry insiders with vested interest in current production processes.
- ❖ Being more efficient hurts industry insiders when that industry faces inelastic demand for its product.



# Why Country Barriers Differ

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- ❖ **Question:** What arrangements have property that it is **not** in best interest of industry insiders to block use of a better technology?
- ❖ **Answer:** Being a member of a free trade club.



# Definition of Free Trade Club

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- ❖ A set of states constitutes a free trade club if
  - Members cannot impose tariffs and restrict imports from other members.
  - Members have a considerable degree of economic sovereignty from collective entity.
  - Countries protect property rights of other member states.



# Why Openness Results in Fewer Constraints

- ❖ Exporters face elastic demand.
- ❖ Domestic industry face competition from foreign firms entering the industry.
- ❖ Just threat of entry may suffice.

# U.S. Golden Economic Era 1865-1929

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- ❖ Per capita income in U.S. went from 75% of U.K.'s in 1865 to 125% of U.K.'s. in 1928.
- ❖ **Why: U.S. became a free trade club.**





# E.U. Level Relative to U.S.

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<u>Year</u>	<u>Original E.U.</u>
1870	62
1913	53
1929	52
1959	53
1973	78
1983	84
1993	102
2002	101



# Why Did the Original E.U. Countries Catch Up?

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- ❖ **Answer:** Original E.U. countries became a *free trade club* like U.S. in 1957.



# Why Being in a Free Club Fosters Higher *Productivity*

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- ❖ No centralized mechanism to block adoption of better production processes in all member states.
- ❖ Export industries in state face elastic demand; implies employment increases when efficiency increases; thus, no vested interests in inefficiency.
- ❖ Exporters have vested interest in continuing membership in club.



# Another Reason

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- ❖ States without groups that will be hurt and with groups that will benefit want the better technology adopted in their state.
- ❖ **Example:** Toyota in 1985 located automobile plant in Kentucky introducing just-in-time production in U.S. A powerful construction industry wanted a construction project. Kentuckians wanted high paying jobs in auto plant. The same thing happened in Wales.



# Why didn't Latin America Catch Up?

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- ❖ Latin America is not a free trade club.
- ❖ If it became one, it would catch up.

# Non Free Club Members Can Be Rich

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 ❖ South Korea and Taiwan are rich.

 ❖ Japan is rich.

 ❖ Singapore is rich.

❖ Hong Kong, Chile, N.Z., Australia,  
Canada, Norway, Switzerland,  
Slovenia, Cyprus, & Puerto Rico also.



# Rich: An Absorbing State

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- ❖ Why: Many small open integrated countries have a vested interest in maintaining openness and it is maintained.
- ❖ Long term economic prospects for Hong Kong economy are good.
- ❖ But, China and India are not small.



# China and India Must Decentralize like U.S. and E.U.

- ❖ Can China sustain openness when rapid growth ceases and is hit by a bad shock?
- ❖ Or will it stagnate and regress as happened in the Ming and Qing Dynasty?
- ❖ I see more hope for India than China in weathering a storm.





# What China Must Do

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- ❖ Reform its banking system.
- ❖ Eliminate credit controls.
- ❖ Then start pegging its price level as in done in the major economies and many small ones.
- ❖ Decentralize power.



# Conclusion

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- ❖ Openness good; trade volumes not critical.
- ❖ Trading clubs promote and sustain openness.
- ❖ Mainland China will become one of the rich industrial countries if only if it decentralizes political power.
- ❖ Becoming open and moving to a market economy is the reason it has been experiences rapid economic growth since the late 1970s.