

CHINA BALANCE SHEET

GROWTH PROSPECTS

The direction that China and U.S.-China relations take will define the world's future. For the United States, a rising China increasingly affects American prosperity and security, calling for some clear-eyed thinking and tough economic, political, and security choices. As the twenty-first century unfurls, the stakes have never been higher for getting U.S. policy toward China right. By untangling the complex, sometimes contradictory, strands of this vast and dynamic country, *China: The Balance Sheet* lays the foundation for informed and effective U.S. policy toward China, the world's emerging superpower.

BACKGROUND

- China has been the **world's fastest-growing economy for almost three decades, expanding at an average pace of almost 10 percent annually.**
- **China is now the world's fourth largest economy** (measured in dollars at current exchange rates) and third largest trader.
- Given its large size, rapid growth, and extraordinary openness to international trade, **it has already become a major source of global economic growth.**
- China's future global role, in both economic and strategic terms, will be heavily conditioned by its economic growth trajectory.

CURRENT SITUATION

- What have been the sources of growth, and are these likely to persist? **Five key factors underlie China's growth: the embrace of market forces, the opening of the economy to trade and inward direct investment, high levels of savings and investment, the structural transformation of the labor force, and investments in primary school education.**
- *Embrace of market forces*
Over the first two decades of economic reform, market forces displaced long-standing nonmarket institutional arrangements. The share of output allocated through the plan fell sharply, and market-determined prices replaced those of the planning authorities for all but a handful of goods and services. In urban areas, job assignment by the state at a fixed wage structure was replaced by a market in which individuals competed for jobs, wages were flexible, and labor turnover was considerable.

For further information, see Chapter 2:

“China's Domestic Economy: Continued Growth or Collapse?”

China: The Balance Sheet: What the World Needs to Know Now about the Emerging Superpower

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- **Progress toward market allocation of investment resources has been slower than for goods and labor**, but the role of the budget in financing investment has declined precipitously and banks are in transition to a commercial orientation in which loans are extended on the basis of expected returns rather than political guidance. Stock and corporate bond markets, however, provide only a small share of investment funds for business expansion.
- Nonetheless, the reform of goods markets has had a positive indirect effect on capital allocation. This is because retained earnings of companies are the single largest source of investment funds and, **in contrast to the early years of reform, productivity and profitability are now highly correlated**. More efficient firms are more profitable and can expand more rapidly, while less efficient firms have lower profits and, on average, grow more slowly or go bankrupt.
- *Opening to global trade and investment*
China has become increasingly open to the global economy, leading to a marked increase in competition. **Trade liberalization has made China one of the most open economies in the developing world**. Imports are almost a third of GDP, much higher than in the United States, and domestic firms also must compete with large quantities of goods produced and sold by foreign firms in China.
- *High levels of savings and investment*
Levels of savings and investment are much higher than in other developing countries at comparable levels of per capita income. This has allowed an exceptionally rapid growth of the capital stock, adding to the economy's productive capacity.
- *Structural transformation of labor force*
The share of China's labor force employed in agriculture has declined from 70 percent at the outset of reform to about 50 percent today. Output per worker in manufacturing and services on average is 16 times that in farming. So, **as workers leave agriculture, major productivity gains ensue**.
- *Investment in education*
Investments in primary school education meant that, on the eve of reform, China had a relatively high literacy rate for a very low-income country, and the government further emphasized mass literacy by increasing mandatory education from five years to nine in 1986. **Basic literacy has been a crucial prerequisite to the creation of a relatively productive workforce in China's large and rapidly growing manufacturing sector**.
Over the next decade, each of these factors should continue to contribute positively to China's economic growth:
- China's WTO commitments are further enhancing the role of the market, particularly in financial, distribution, and other services—domains where the introduction of market forces had lagged compared to the goods and labor markets.
- High levels of household savings are likely to persist for another decade, and the share of the labor force still in agriculture will continue to shrink.
- Finally, China is likely to continue to emphasize investments in education.

IMPLICATIONS

- Looking ahead for the next five to ten years, **it would be prudent for the United States to base its own strategy on the assumption that China will continue to grow rapidly** and become an ever more significant factor in the global economy.
- **A significant economic slowdown for several years or even a collapse cannot be entirely ruled out**, but the strong likelihood is that China's leadership will undertake the further reforms necessary to sustain its rapid economic growth.