

China: the world's largest economy

“Let China sleep. For, when she wakes up, the world will tremble” – Napoleon Bonaparte, about 200 years back.

*“Transformations that in other countries took centuries to accomplish had been telescoped into a few decades in China” -- Pallavi Aiyar in *Smoke and Mirrors (An Experience of China)*.*

The recent, well publicised visit of the Chinese President to the United States, and the news that, as estimated by Arvind Subramanian of the Peterson Institute of International Economics, China's GDP in purchasing power parity terms is already larger than that of the United States, have obviously attracted a lot of media attention (to be sure, some economists disagree with Prof. Subramanian's methodology): the Financial Times recently published a series of articles with the collective heading *China shapes the world*, proving Napoleon's point. In terms of GDP at the market exchange rates, it is the second largest, next only to the U.S. (it ranked 6th as recently as 2001), and is projected to become larger than the U.S. by 2017. The difference in the two GDP calculations can be easily understood by looking at the addition, say, a haircut makes to GDP – at market exchange rates, this is roughly \$ 1 in India and perhaps \$ 20 in the U.S. PPP calculations are made on the basis that a haircut should add the same amount to GDP. Even in an increasingly globalised world, such price disparities remain, particularly in the non-tradeables sector.

The astounding growth rate of the Chinese economy (10% p.a. compound, on an average, between 1979 to 2010), unparalleled in global economic history, and its current size, mean that Chinese economic power and global influence will be increasingly felt in the 21st century. (A corollary would be the internationalization of

the yuan.) The growth is a tribute to the pragmatism of the post-Mao Chinese leadership, and their purposeful pursuit of the strategic objective of beating the “barbarians”, as Chinese call foreigners, and re-occupying the prime place in the globe it had occupied until the 15th century.

As a global economic superpower, it also has a large problem on hand: the re-balancing of economic activity with much lesser reliance on exports for growth (China became the largest exporter in the world, beating Germany into second place, in 2009), and an increasingly larger contribution from domestic consumption: she needs to accomplish this as much to mitigate western pressures to up-value its currency faster, as to improve the people’s living standards, even while maintaining fast growth rates and employment creation. In 2010, for example, its 10.2% growth led to the creation of an estimated 20 mn jobs. Job creation on a massive scale, and continuing improvements in the standards of living and consumption of the people, are a must for social stability which the leadership values above everything else, and also to provide legitimacy to the one party rule of the Communists, even when they have abandoned the tenets of socialist ideology three decades back.

In one way, the rebalancing is already on the way. As recently as 2007, the current account surplus was 11% of GDP; it had come down to a little less than 6% by 2009, but has gone up marginally in 2010. The IMF projects it to go up further gradually to 8% by 2015. This would surely exacerbate trade friction. In comparison, Japan’s surplus was about 4% of GDP in the 1980s, when it was accused of mercantilism, of wanting to take over the world, and pressurized into allowing its currency to appreciate fast. The stagnancy of the Japanese economy in the last two decades is obviously an example which the Chinese leadership would be wary about, while framing its policies.

Growth has been maintained despite the sharp fall in the current account surplus, not by increasing domestic consumption, but by increasing investment. Consumption accounts for just 36% of GDP, roughly half of other large economies. Household

sector savings are not too different from India's but the main difference comes from savings of the corporate sector, particularly the public sector. As Nouriel Roubini wrote recently in Newsweek, "*... no country can be so productive that it can take, every year, half its GDP and reinvest it into more capital stock without eventually ending up with a huge excess capacity and a mountain of bad loans. Thus, China needs to radically change its growth model from net exports and investment to reduced saving and more consumption.*" One way adopted by the authorities to increase consumption is a sharp rise in wages in the agricultural and manufacturing sectors: 15% average last year. Another, perhaps more lasting, would be a sharp hike in dividends by the public sector – and using the funds to improve social security; the less than adequate old age pensions and public health services are also reasons for the high savings rate.

Howsoever the rebalancing takes place over the medium term, the fact is that, in the 21st century, China will be the most powerful force in the global economy, a point I shall revert to next week.

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