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## Asia in the 'Catch-Up' Game: 1[1]

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### Executive Summary

Two developments, the first decades old and the second very recent, have reshaped and are re-shaping the global economic landscape. The first was the process of globalisation that reduced the distance among different economies in the world, not in the physical sense, but in the sense of easy flow of capital, trade, information and technology. Globalisation has produced a global economy the like of which the world has never known, and the process will continue to move forward the global economy.[3] The future course of the world economy is one of the main issues addressed in the study. The second development was what economists and financial experts call the Great Recession of 2007-09 to distinguish it from the Great Depression that took such a heavy toll in the 1930s. What was 'great' about this particular downturn in economic activity was that its origins were not in the normal working of the large economies that produce trade

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1 This is a revised version of an earlier draft which was discussed at an ISAS seminar, "Asia in the Catch-Up Game" held on 9 March 2010. Several helpful comments and suggestions made by participants at the seminar have been incorporated in this version.

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3 Globalisation has attracted a great deal of academic and policy attention ever since the process was recognised as an important contributor to changing the shape and structure of the global economy. It has been studied from both the left and right sides of the political spectrum. For the former, see Joseph Stiglitz, *Making Globalization Work*, New York, W.W. Norton, 2002. For the latter, see Jagdish Bhagwati, *In Defense of Globalization*, New York, Oxford University Press, 2004; and Martin Wolf, *Why Globalization Works*, New Haven, Conn.: Yale University Press, 2004.

cycles with some frequency. The slowdown that now seems to be winding down was great for several reasons. The ferocity with which it struck; it took the form of an economic tsunami that not many had predicted. It hit many shores. It was caused not by the normal ups and downs in economic activity but by misplaced faith in the rationality of the markets. And it is likely to change dramatically the structure of the global economy. It is this final aspect of the Great Recession that is the subject of this inquiry.

Going back to the analysis of "catch-up" offered by Alexander Gerschenkron, the premier economic historian of the twentieth century, the role the state plays in the process acquires special significance. In this regard, it is particularly important to note what governments can do to better the lives of their citizens. The government's role as an economic player was relegated to the back benches in the 1980s by the economic philosophy that accompanied Ronald Reagan to the White House. Called *The Washington Consensus*, this view left the private sector to its own devices, even to regulate itself. Forced on the back-bench, the state remained there until it was called upon to act again to save the world economy from collapsing in 2008. Summoned back, the state acted impressively in both developed and developing countries. China brought the state back with vengeance. The United States (US), by intervening in the financial markets and the automobile industry, dramatically increased the role of the state. Many other countries, including India in Asia and the European Union (EU) in the West, followed the same path. It is interesting to note that even the Chinese had succumbed for a while to a weaker version of *The Washington Consensus*. There is considerable irony in the fact that an avowedly socialist economy was tempted for a while to adopt some aspects of neo-liberalism for managing the economy. With the state having roared back to life, what will it do to shape the character of the Chinese economy? This is yet another question in this exercise.

Taking a cue from those who have studied various episodes of "catch up" in economic history when some of the economies that lagged behind caught up with the leader, this paper investigates the latest such development. This involves China, which some time in 2010 is expected to become the second largest economy in the world, overtaking Japan which held that position for several decades. This is a particularly relevant occurrence for Asia not because an Asian economy is replacing another. This is significant because the structure of the Chinese economy and its character are changing in ways that will matter enormously for the rest of Asia. While Japan is from Asia, after its economy became "developed", it joined the ranks of those that were advanced and developed. Japan's linkages with Asia are weak; but those of China are becoming strong. A good indication of this is the inauguration of the China-ASEAN Free Trade Area on 1 January 2010 that will have profound consequences for the economies in its periphery.[4]

Unlike some of the earlier ‘catch up’ instances, China, having almost overtaken Japan is expected to bypass the US in the next several decades. It will remain a relatively poor country dependent on the rich for markets and technology. This introduces an entirely new dimension in the “catch up” game. For many decades to come, the global economy will be dominated by two economies that will not compete as much as Britain and France did during the first catch up episode a couple of centuries ago, but complement one another. Notwithstanding the current exchange of difficult words between Beijing and Washington, the global economic architecture can neatly arrange itself into three tiers: the US and China at the top (the G2); a number of secondary powers in the middle (a reformulated G20); and the rest of the world forming the base of the pyramid. Those who believe that such a system dominated by two economies will not be stable, derive the wrong lesson from the Cold War when for four decades the US and the Soviet Union confronted one another, sometimes with murderous intent. It was only the mutually assured destruction made possible by the possession of thousands of nuclear weapons by the two sides that prevented the globe from being reduced to a giant mushroom cloud. It is not necessary that a great power must always beat back competition and seek total domination. When competing powers need each other as do the Americans and the Chinese, they will learn to work with each other. This is expected to happen within the context of the architecture outlined in this paper. But the development of such architecture will need deliberate action by some of the more important governments in the world.

While mutual dependence is likely to create equilibrium in the global economy and keep the political system in balance, can the same be expected in Asia? The continent has not one, or two, but three great economic powers. While Japan does not seem concerned with the second rank that it is soon likely to assume in the continent in terms of the size of the economy, will India be content to be the third? More importantly, will it be prepared to be relegated to the emerging second tier in the hierarchical structure for managing global economic affairs? Answering these questions will require deep and intensive research. For the moment, it is important to underscore that for India to gain the economic and political stature it desires, it will need to achieve a number of things: tranquility around its borders; an economic system that delivers to the less advantaged segments of the population, particularly in terms of education and skills development; development of physical infrastructure that can support a rapidly growing and modernising economy; and an economy that is more outward-oriented so that it can take full

[4] Not many observers of the Asian scene believe that the regional arrangements are working as well as suggested by their proponents. See, for instance, *The Economist,* “South-East Asian Summitry: Distant dreams”, 31 October 2009, p.37.

advantage of the rapidly changing systems of trade and production. If it is able to achieve most of these things, there is no reason why some time in the future the system's apex cannot expand from the G2 to the G3.

## Introduction

Among those who have speculated about the future shape of the global economy are analysts who have suggested that the twenty-first century will be the Asian century.[5] They believe that for many reasons, the US has lost or is in the process of losing, the momentum that propelled it forward in the process of economic development and social change during the twentieth century. The dynamics that produced that momentum made it possible for the country to overtake Europe beginning from the early years of the twentieth century. For more than a hundred years, the US was able to maintain its position as the preeminent global economic power. It achieved that status by following a model that can be loosely described as "liberal capitalism". Its main feature was the confidence that was placed in private initiative. The state had a minimal role, confined to defending the country's borders and its strategic interest, regulating some aspects of the working of the private sector and providing a limited number of services to the citizenry. The state's role increased during periods of economic stress – during the Great Depression of the 1930s and, more recently, in the Great Recession of 2007-09 – only to pull back once conditions stabilised.

One important outcome of the Great Recession was the sharpening of the trend in terms of the catching up of Asia or parts of it with the world's richer countries. Several Asian economies are rapidly closing the economic gap with more developed countries. This was not supposed to happen according to conventional thinking. That thinking held that with the Asian economies so closely tied with the industrial world and so dependent on those markets, they will suffer a great deal as the Western markets contracted. With that engine of growth lost, the Asian train will begin to drift and inevitably slow down. As *The Economist* wrote in a survey published in August 2009, "Westerners have always been quick to pronounce the death of the Asian economic miracle, but it also reflects some misunderstandings about the ingredients of Asia's success. This year it was widely predicted that Asia's economies would not recover until after America and Europe had revived. Yet Asia's supposedly export dependent economies have resumed growth before the rest of the world."[6] Why were pessimists about Asia once again

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[5] There is a growing body of literature on this subject. Some of the more important works belonging to this genre are Fareed Zakaria, *The Post-American World*, New York, Penguin Viking, 2008; Kishore Mahbubani, *The New Asian Hemisphere*, New York, Public Affairs, 2008; and Martin Jacques, *When China Rules the World: The Rise of the Middle Kingdom and the End of the Western World,* London, Allen Lane, 2009.

[6] *The Economist*, "Briefing: Emerging Asian economies on the rebound", 15 August 2009, p. 59.

proven to be wrong? Three things helped Asia: an aggressive role of the state, populations that are still young, and the economies that function well within many regional arrangements. These three elements are working together to develop a pan-Asian market. The significance of this development is often lost on those in the West who are watching developments in the Asian continent. This paper will produce a perception somewhere between the American politicians and the European historians. It will suggest that the US' decline will not be in absolute terms; it will only be in relative terms. For the rest of this century, it is likely to remain the world's premier economy but with China close on its heels.

It appears that the Great Recession of 2007-09 may have accelerated the process of what many analysts have called the "decline of the United States".[7] Among those who have espoused this point of view is the British historian Paul Kennedy. His *The Rise and Fall of Great Powers* (1988) is still widely read. According to Kennedy, ascendancy of states or empires has usually resulted from the superiority of their material resources. However, the wealth on which that dominance has been built up can be eroded because of the huge military expenditures needed to sustain national or imperial power. This burden on the state leads inexorably to the decline and fall of great powers. The debate regarding the US' possible decline became sharp enough in 2010, encouraging Vice President Joseph Biden to throw his weight in favour of those who maintain that the US was too big a country to lose. Despite the persistent budget deficit and crushing burden of projected debt, Biden does not think that the country is "destined to fulfill a prophecy that we are going to be a great nation that has failed because we lost control of our economy and [got] overextended."[8] Those who see the US sliding with a little chance of recovering its balance do not accept this sanguine view. According to Piers Brendon, another British historian, "in any debate about the development of the US one would certainly tend to side with the detached historian rather than the partisan politician."[9]

If the US loses its economic prominence, which countries and regions will benefit from the pull back? What will be the consequences of this change? Will the realignment among countries in the global economic system come about with or without open conflict? What could be the possible institutional arrangements to emerge as the pace of transition picks up while some of the Asian economies take their seats in the front row? These are precisely the issues that were discussed as the Second World War was drawing to a close when the victors assembled at

7 See Paul Kennedy, *The Rise of the Great Powers* (New York, Vintage, 1988). Also among those who have espoused this point of view is economic historian Niall Ferguson in a number of contributions he has made to the op-ed columns of several newspapers, most notably the *Financial Times*. See for instance, "A Greek crisis is coming to America", *Financial Times*, 10 February 2010, p. 11.

8 Piers Brendon, "The US is dead, long live the US", *The New York Times* reprinted by *The Straits Times* (26 February 2010), p. A26. The Biden quote is also from the Brendon article.

9 Ibid.

Bretton Woods, a small resort in the state of New Hampshire in the US, to fashion a new global and economic financial order. Will there be a fundamental remaking of the Bretton Woods system created in 1944? Providing some answers to these questions is the main objective of this paper.

One further point needs to be underscored. As discussed in the second section of the paper, Asia is at the forefront of the enormous change that is occurring in the shape of the global economy. There are several reasons for this and these have been identified in a number of scholarly works. Two of these will receive particular attention in this paper. One, the role the countries in Asia have assigned to the state. Two, the enormous demographic change that is occurring in Asia and its impact on the way economies develop. This is a subject often ignored in economic literature. The paper will seek to make a definitive contribution in this regard.

There are many differences in the way the state has helped with the process of economic development in different parts of Asia. That said, one element was common to all the different models that were followed: the state did not surrender most economic authority to the private sector. As already indicated, this was the main feature of the American model particularly during the time that President Ronald Reagan governed from Washington. In fact during that time a consensus had developed among several economic, financial and development institutions dotting the Washington landscape. According to this, the state should leave the private sector mostly to its own devices. This came to be known as *The Washington Consensus* with Alan Greenspan who served as Chairman of the Federal Reserve Bank as its most ardent advocate.[10] Later, when the private sector was seen to have forfeited its claim to unerring rationality by placing so much of the financial sector under great stress, Greenspan and those who believed like him made some adjustments in their point of view. According to Robert Skildelsky who in his book, *Keynes: The Return of the Master*, studied the circumstances that led to the revival of Keynes, "another line of retreat is to say with Alan Greenspan, that disaster such as the present are (unexplained) once-in-a-century events, and that most of the time markets behave in perfectly rational ways."[11] If this point of view continues to prevail, there will be further distancing between the Western and Asian economies.

The paper is divided into two parts. This first part of the paper begins with an introduction. The section that follows provides a broad outline of the "catch up game". This draws upon the work

[10] Alan Greenspan, *The Age of Turbulence: Adventures in a New World,* New York, The Penguin Press, 2007.
[11] Robert Skildelsky, *Keynes: The Return of the Master* (New York, Public Affairs, 2009), p. 46.

of not only Alexander Gerschenkron but also Angus Madison[12], who has used reams of historical data to identify the various "catch-up periods" in economic history. While drawing upon these and other works, a number of new dimensions are added to study the state of flux that currently exists in the global economy as consequences of the rapid economic rise of some of the Asian economic powers. The next section deals with the rise of China as an economic superpower. In discussing this development, the paper departs from conventional thinking and emphasises the role played by Mao Zedong, the founder of the modern Chinese state. A number of recent works on Mao have accentuated the negatives; this paper will underscore some of the positives.

## Asia and the Catch-Up Game

Studying catch-up economies became a popular pursuit as economists began to understand the process of economic growth. The first insightful study in this area was done by the Harvard economic historian Alexander Gerschenkron.[13] He first studied the industrial revolution in England and concluded that it came about because of a fortuitous combination of a number of seemingly unrelated circumstances. These included, in particular, technological revolution – development of the steam engine, for instance and entrepreneurship. Specialisation in production processes, enlargement of the markets through international trade, and the arms length approach of the state to the private sector were identified by Adam Smith as some of the reasons that made it possible to accumulate national wealth. Smith's seminal work, *The Wealth of Nations,* went on to become the bible of economics, more accurately classical economics.[14]

Having studied the economic rise of Britain, Gerschenkron turned his attention to Western Europe. Once England had shown the way, the countries that had been left behind were anxious to catch up. France was the first to work on that process with the French state playing an active role. Germany was the second country to play the catch-up game. In this case, it was the close relationship between finance and industry, encouraged by the state that helped the country to get even with the front runners. An interesting corollary of Gerschenkron's interpretation of economic history is that the initial conditions that produce economic advance retain their influence on policymaking for a long time to come. Britain continued to follow the laissez-faire model; France has kept the state actively involved in managing the economy; and in Germany, there continues to be a deep relationship between industry and finance.

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[12] Angus Madison, *The World Economy: A Millennial Perspective/Historical Statistics* (Paris, Organization for Economic Cooperation and Development, 2007) and *Essays in Macro-Economic History,* New York, Oxford University Press, 2007.

[13] Alexander Gerschenkron, *Economic Backwardness in Historical Perspective: A Book of Essays*, Cambridge, Mass. Belknap Press of Harvard University Press, 1962.

[14] Adam Smith, *An Inquiry into the Nature and Causes of the Wealth of Nations*, New York, Penguin, 2000.

The US joined the game in the last few decades of the nineteenth century. In its case, natural endowments, some extraordinary technical advances, and a government structure that allowed a great deal of space to private entrepreneurship, helped. America not only caught up with Europe, it overtook the latter in terms of the size of its national product and average per capita income of its citizens. This happened in the period leading up to the First World War. Europe, weakened by the war, was left behind by America and for about half a century, the US was the sole economic superpower.

Gerschenkron also studied the economic history of the Soviet Union in the catching-up context. Moscow launched a catch-up experiment of its own in 1917 with the Bolshevik revolution, which resulted in an enormous expansion of the state. But the state did not follow the French model which had it pushing the private sector hard. The Soviets wished to leap frog over other relatively more developed economies by pushing aside private enterprise. The state was to do it alone. The Planning Commission manned by both economists and mathematicians was assigned the task of writing the Five-Year Plans. These were in fact detailed production plans that indicated where and what the state was going to invest. The rate of growth of GDP was to be quickened by concentrating on heavy industry. The inputs needed for the planned industries and the outputs they were to provide were worked out in great detail by using the input-output tables that the Soviets had the mathematical skills to run. The model did not succeed and the Soviet Union was unable to engineer a "catch-up" economy. That task was left to the successor Russian state.

After the Second World War, it was Japan that successfully played the catch-up game. By the end of the 1970s, in terms of average per capita income, Tokyo was equal to that of the advanced countries of Western Europe and the US. It was not able to overtake the US in terms of the size of the economy simply because it had a much smaller population. Japan's extraordinary story of economic success was studied by scholars from several disciplines. Ezra Vogel, a Harvard University sociologist, was one of those whose work, *Japan as Number One* (1979), became a best seller.[15] He argued that Japan, by combining a style of governance with a culture that supported entrepreneurship, had found a unique way to promote economic growth. Vogel thought it would not be long before Japan will have the largest economy in the world and per capita income much higher than that of the US.

The Japanese model of growth involving a significant reduction in the distribution of income and assets; an active role by the state; large investments in the development of human resources; letting the state's economic policies be formulated and implemented by a highly educated and

[15] Understandably the Vogel book did extremely well in Japan. See Ezra F. Vogel, *Japan as Number One: Lessons for America*, New York, Universe, 1999.

trained bureaucracy; and focus on exports to provide outlets for domestic enterprises was adopted by several countries in East Asia. They were able to accelerate their rates of growth to the point where, by the first decade of the 21st century, Singapore's per capita income approached the levels of America and Western Europe.[16] The East Asian nations also began to break into what were once exclusive clubs figuring only the rich states. South Korea, for instance, joined the Organization for Economic Cooperation and Development (OECD) in 1996. On 1 January 2010, it was admitted into the Development Assistance Committee (DAC) of the OECD, becoming its 24th member.[17] The Paris-based OECD is considered to be the rich countries' club. Both Singapore and South Korea were included among the countries that came to be called East Asia's "miracle economies."[18]

While China was not initially counted among the miracle economies, its growth picked up in the early 1980s and has been maintained for more than a quarter century. The Chinese economy, in its quest for achieving high rates of growth, has gone through two phases in recent years.[19] In the first, the country followed the model of growth pursued by the miracle economies of East Asia by relying on exports to the Western markets. The second phase started with the Great Recession of 2007-09. The Chinese have begun to reorient their economy towards domestic consumption and greater integration with the Asian markets. They have put in place structural changes that will have profound implications for the future of rest of Asia.[20]

China's second rise "could accelerate Japan's economic decline as it captures Japanese export markets, and as Japan's crushing national debt increases and its ageing population grows less and

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16 Some Japanese economists have developed the "flying geese model" of adoption and adaption of their country's approach to development by other East Asian states. The model was originally conceived in the 1930s by economist Akimatsu Kanane to help Tokyo design industrial policy for accelerating the pace of industrialisation. He developed the notion of "sunrise" and "sunset" industries to distinguish between those activities the state should encourage and those that it should phase out. The model was later extended to see how Japan could help other Asian countries follow the same path. See Pekka Korhonen, "The Theory of the Flying Geese Pattern of Development and Its Interpretation", *Journal of Peace and Research*, Vol. 31, No. 1, pp. 93-108 (1994).

17 To become a DAC member, a country's aid program must either exceed 0.2 per cent of its Gross National Income (GNI) or be more than US$1 billion a year. It must also have appropriate aid organisations and policies and strategies in place to guide the aid program. South Korea's official development assistance in 2009 amounted to approximately US$830 million or 0.09 per cent of its GNI. However, by 2015 the country plans to increase of its total aid to US$3billion or 0.25 per cent of GNI. It was this plan that won its membership of DAC.

18 The case of the miracle economies has been studied at some length from a number of different perspectives. Among the more insightful works in this context is a study prepared by a group of economists working at the World Bank. The group was led by John Page with the author working as one of the advisors. The group wrote a study that examined the factors that had contributed to the East Asian miracle. See The World Bank, *The East Asian Economic Miracle: Economic Growth and Public Policy*, New York, Oxford University Press, 1993. The findings of this study continue to influence policy- makers worldwide.

19 There were actually four discernible phases as discussed below in the paper.

20 Shahid Javed Burki, "The Rise of China: How It Will Impact The World", Institute of South Asian Studies, Insight No. 80, 6 August 2009. http://www.isas.nus.edu.sg/Attachments/PublisherAttachment/ISAS_%20Insights_%2080_21102009214442.pdf. Accessed on 31 March 2010.

less productive – producing a downward spiral" wrote Hiroko Tabuchi in *The New York Times* . "At stake are more than regional bragging rights: the reversal of fortunes will bring an end to a global economic order that has prevailed for more than 40 years, with ramifications across arenas from trade and diplomacy to, potentially, military power."[21] The relative positions of China and Japan have been discussed later in the paper.

India has also begun the catch-up game. This began in the mid-1980s when policy makers in New Delhi abandoned the model of economic growth adopted by Jawaharlal Nehru after the country gained independence in 1947. Nehru was the country's first prime minister and stayed in that position for 17 years until his death in 1965. Having been greatly influenced by the Soviet model of economic development, Nehru and his economic advisors put the state on the commanding heights of the Indian economy. This is where it stayed for four decades.

The government intervened in the economic process by instituting what came to be called the "*license raj*". The state sanctioned the establishment of new industries and the expansion of those that were already working. It also created an elaborate system of controls on external trade including the allocation of supplies needed by industry. In addition to controlling the working of the private sector, the state undertook large investments in industry. The sectors chosen for particular state attention included steel and other metals; manufacture of capital goods; electricity generation, transmission and distribution; and transport, particularly railways and airlines. Finance was added later to the sectors for which the state had the primary responsibility. This happened in 1969 during the tenure of Indira Gandhi, Nehru's daughter.

While the state began to ease its control over the economy starting in the mid-eighties, it was only in 1991 that the then Finance Minister Manmohan Singh dismantled the "*license raj*" altogether. The economy responded to this change dramatically and the rate of growth in GDP doubled from what the late Indian economist K.N. Raj called the "Hindu rate of growth". From 1951 to 1980, India's GDP increased at the rate of 3.5 per cent a year while its population grew by 2.2 per cent. The increase in per capita income averaged 1.3 per cent a year, not high enough to reduce the incidence of poverty. The proportion of the poor population increased from 45.3 per cent in 1951 to 47.3 per cent in 1980. However, from 1980-81, the rate of economic growth accelerated to 5.7 per cent per annum while per capita income growth increased to 3.6 per cent a year.[22] There was a further increase in the rate of growth of GDP expansion during the period 1997-2007. How will India reposition itself in the Asian and global economies in the years to

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[21] Hiroko Tabuchi, "China's day arriving sooner than Japan expected", *The New York Times*, 2 October 2009, pp. B1and B2.

[22] Arvind Virmani, *Propelling India from Socialist Stagnation to Global power: Growth Prospects*, New Delhi, Academic Foundation, 2006.

come? What are likely to be its economic relations with China? Will New Delhi gain the position it inspires in the global economic and political systems? These are some of the questions that have not been addressed in this paper but will be done in subsequent studies.

Chart 1 provides projected estimates by Goldman Sachs of national incomes for the 22 largest economies in the world during the years 2025 and 2050. While such long-term forecasts seldom turn out to be correct, what is interesting about the projections are some of the suggested changes that may occur in the ordering of the global economies. There is a fairly significant realignment of the economies during the next 15 years. By 2025, the world economy is likely to be dominated by the US and China, each with national incomes close to US$20 trillion in 2006 prices. Japan, the next largest economy, is likely to be only a quarter of the size of these two economies. India is expected to be in the fourth position with its national income slightly less than that of Japan's. By that time, the G7 as currently constituted, will not represent the largest economies in the world. Indeed two from the G7 are already from what is called the emerging world.

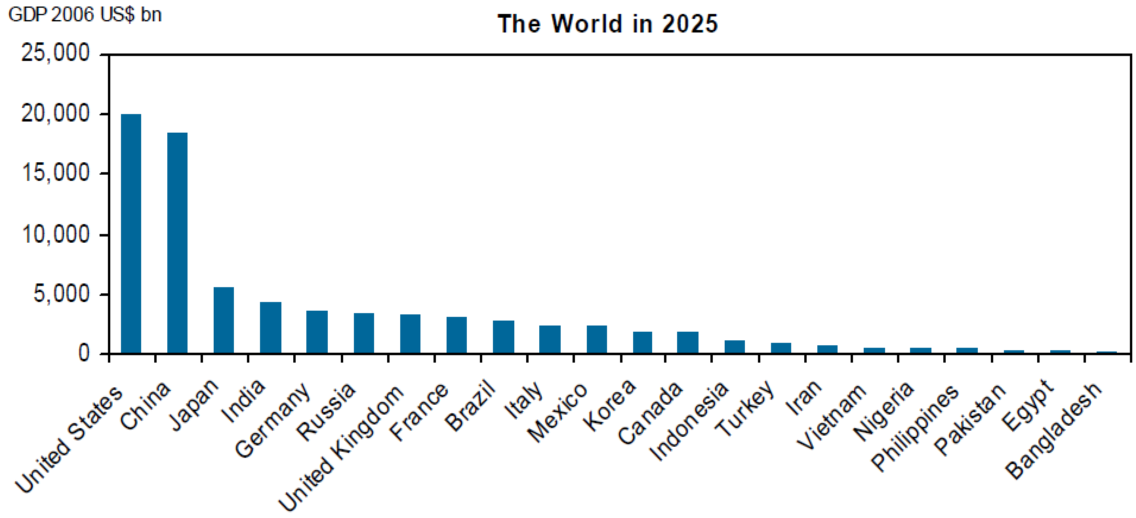
Eleven of the 22 largest economies are from Asia. In the 25 years that are to follow, there is further realignment with China overtaking the US. China's GDP is expected to increase to US$70 trillion, three and a half times of its GDP in 2025. The US economy will also increase but only double its size, to US$40 trillion. India, according to these estimates will be almost equal in size to the economy of the US. What do these increases in the size of the economies suggest about their rates of GDP growth? To increase three and half times over a period of 25 years implies an annual average rate of growth of 5.2 per cent. For the US, the implied rate of growth is 2.9 per cent; for India, it is 8.7 per cent. These are in line with the consensus view of most economists. The question is whether these averages can be maintained over such long periods?

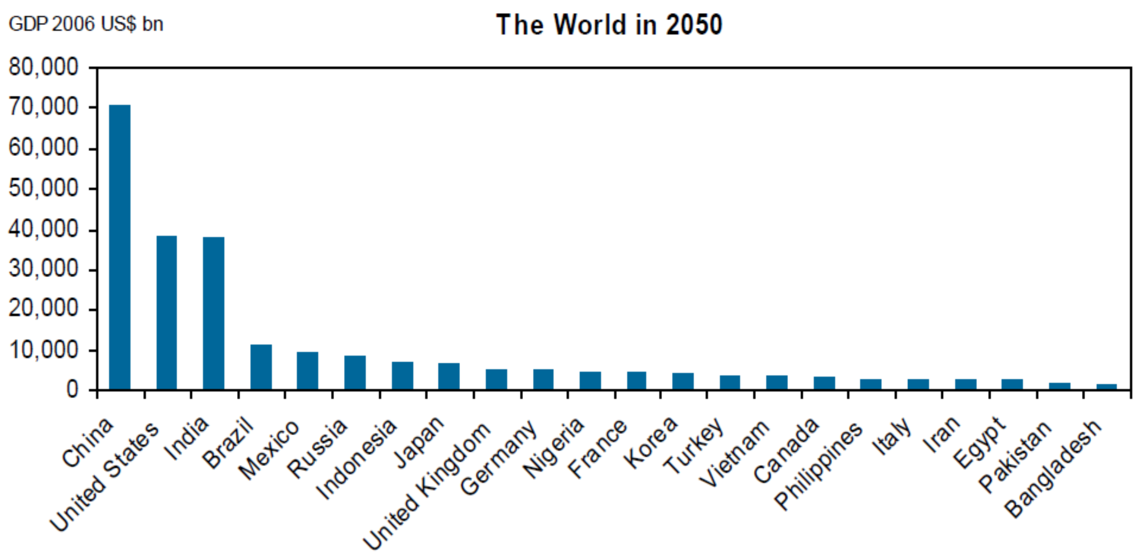
There will be other significant changes as well. Japan's relative decline will continue. It will drop from the third position in 2025 to the eighth in 2050. The country's rate of GDP growth will be less than one per cent a year. Some other current leaders in the world economy will also see major changes in their relative ordering. Germany will drop from being the fifth largest in 2025 to the tenth largest in 2050, UK from the seventh to the ninth and France from the eighth to the twelfth. Of the many surprises in these estimates is the change in the relative positions of the European economies with Britain becoming the largest in the continent. No European economy will figure among the five largest in the world.

Indonesia and Nigeria will see major improvements in their positions; the former will improve from the $14^{th}$ position in 2025 to the $7^{th}$ while the latter will jump from the $18^{th}$ to the $11^{th}$. Some of the Latin American economies are also expected to do well. Brazil and Mexico will become the world's fourth and fifth largest economies respectively, moving up from the ninth and eleventh positions. Among the world's five largest economies in 2050, two – China and India – will be Asian, while another two – Brazil and Mexico – will be Latin American and the fifth, will be the US. This will make the current G7 grouping totally irrelevant; the US will be the only country from this group that will still be among the seven largest economies in the world. It is clear that the need for revising the current institutional structure will increase with every passing year.

What are the main drivers of growth visualised by Goldman Sachs? Three of these are critical; expected increases in the size of the population; access to natural resources; and trade competitiveness. More populous countries will do relatively well, particularly those investing in improving the quality of human resources. For countries experiencing declines in population size (this includes all countries in continental Europe as well as Japan) aging populations will begin to weigh increasingly on economic performance. As the centre of gravity of the global economy shifts towards the emerging world, the use of natural resources, in particular oil, will increase. This is one reason why the oil-rich countries do relatively well in these estimates.

**Chart 1:**




**Source:** The N-11: More Than an Acronym, Global Economics Paper No: 153, Goldman Sachs, 2007.

The inclusion of international trade as a growth driver suggests further globalisation in production processes. Trade as a proportion of total international output will continue to increase and countries that are geared to take advantage of this development will do relatively well.

**Table 1:**

| **The World in 2025** | **The World in 2050** |
|---|---|
| 1. United States | 1. China |
| 2. China | 2. United States |
| 3. Japan | 3. India |
| 4. India | 4. Brazil |
| 5. Germany | 5. Mexico |
| 6. Russia | 6. Russia |
| 7. United Kingdom | 7. Indonesia |
| 8. France | 8. Japan |
| 9. Brazil | 9. United Kingdom |
| 10. Italy | 10. Germany |
| 11. Mexico | 11. Nigeria |
| 12. Korea | 12. France |
| 13. Canada | 13. Korea |
| 14. Indonesia | 14. Turkey |
| 15. Turkey | 15. Vietnam |
| 16. Iran | 16. Canada |
| 17. Vietnam | 17. Philippines |
| 18. Nigeria | 18. Italy |
| 19. Philippines | 19. Iran |
| 20. Pakistan | 20. Egypt |
| 21. Egypt | 21. Pakistan |
| 22. Bangladesh | 22. Bangladesh |

**Source:** The N-11: More Than an Acronym, Global Economics Paper No: 153, Goldman Sachs, 2007.

**The rise of China and which way will it go?**

China's remarkable economic performance has been the subject of much study by the practitioners of many disciplines. There are several ways of looking at the country's remarkable economic and social progress over the last sixty years. This paper emphasises on the working of the Chinese state particularly during economic stress. The discussion to follow will illustrate how the state has been improving its capacity to manage the economy by mentioning the author's own experience of dealing with some of the senior Chinese leaders in 1991 when the state, worried by rapid increase in inflation, was anxious to develop a set of instruments for dealing with the problem.

Four distinct phases have been identified in China's emergence as an economic powerhouse and as a global player.[23] It is useful to go back to some of that history since it helps to better understand the problems that China faces today as well as gauging its prospects. It all started with the effort launched by Mao Zedong that lasted for almost three decades, from the arrival of the Chinese Communists in Beijing on 1 October 1949 to the death of the paramount leader on 9 September 1976. During this period, in spite of several policy missteps that resulted in the deaths of millions of people, Mao was able to transform China socially. He brought universal literacy and healthcare to the citizenry and introduced gender equality into the Chinese social system. Without the human base Mao built, China's second phase, launched by Deng Xiaoping, would not have achieved economic success. However, it is possible to argue that what Mao was able to achieve could have probably been done at a lower human cost. This brings on the difficult realm of counter-factual history with the possibility of deviation from the main objectives of this paper. Deng set the stage for pushing back the worst aspects of Communism in favour of opening the economy to private initiative. This was Deng's "Communism with Chinese characteristics".[24]

Deng's approach to reform was very different from that pursued by Mao. While Mao believed in revolution to bring about what he considered the desired aim, Deng's modus operandi was incrementalism. Almost all his major efforts were undertaken first as pilot projects. They were

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[23] Shahid Javed Burki, *Changing Perceptions, Altered Reality: Emerging Economies in the 1990s,* Washington DC, The World Bank, 1999.

[24] The author saw from very close quarters the way the Deng system of reform was implemented in his capacity as the World Bank's Director of China Operations for seven years, from 1987 to 1994. During this period, the World Bank's lending increased from US$500 million in 1987 to over US$3 billion in 1994. The Bank worked with the Chinese on a number of areas of reform and economic modernisation. Among them was housing reforms. The Chinese were persuaded to allow the private sector into the housing area by taking away from state-owned enterprises the responsibility of providing shelter to their employees. This was a major step which Beijing took after experimenting with transition from one system to another in a couple of cities including Qingdao, the home of the famous Chinese beer that carries the city's name.

introduced in other parts of the country only if they succeeded initially. The decision to return to the original owners the land acquired by the communes was first tried in Sichuan province. It was a resounding success as both productivity and output increased. Agriculture, with massive increases in output and productivity, was the first to benefit from this dramatic policy change followed by small scale industry and short-distance commerce. At the forefront of this effort was the town and village enterprise, or TVE, owned by the communities. This was a uniquely Chinese business organisation. This second phase lasted for about a decade. The third was also inspired by Deng who encouraged Chinese enterprises to partner with those in the West. There were three reasons why China gave up enforced isolationism of the Mao period in favour of greater openness, including opening to the West, in particular the US. It brought new technologies and management practices to China. It found new markets for the rapidly increasing output of the industrial sector and promoted China as an active actor on the global economic stage. China is now entering the fourth phase and is about to become the second largest economy in the world overtaking Japan sometime this year or in 2011. This has been an amazing trajectory to follow. Will it last?

After growing at rates close to an average of 10.0 per cent per year for the last quarter century, the Chinese economy suffered a slight setback in 2008, largely due to the Great Recession of 2008-09. This was not the first decline in the rate of economic growth the country had maintained for a quarter century. However, the state stepped in to get the economy out of the difficulties it faced as a result of the collapse of the markets in the West. To the surprise of many China-watchers, the economy recovered at an unexpected pace, much higher than estimated by most. That this happened before there was recovery in other parts of the global economy is a testimony to the strength of the Chinese economy. When the Chinese economy began recovering, the global economy was in a deep recession and the Chinese dependence on the markets in developed countries was expected to hurt it badly. That did not happen. China's GDP expanded by 8.7 per cent in 2009, beating the expectation of most analysts who estimated that the increase will be about 7.2 per cent. The GDP growth, however, was much lower than the 11.9 per cent growth recorded in 2007. It was still remarkable, given the sluggishness in other parts of the world. China achieved this impressive rate of growth in spite of a fall in the rate of real export growth from 20.0 per cent in 2007, to 8.0 per cent in 2008 and -10.0 per cent in 2009. According to one assessment, "China may have accounted for as much 2.0 percentage points of annualised growth in inflation-adjusted world output in the second quarter of 2009."[25] This was possible since the country does not appear to have been that dependent on exports to the Western markets as was believed earlier. It may lead the emerging economies to move towards

[25] Stephen Roach, "I've been an optimist on China. But I'm starting to worry", *Financial Times*, 29 July 2009, p.20.

"decoupling", a concept according to which they are no longer very closely linked with the world's rich nations, moving in tandem with them.

China's rapid recovery from the setback caused to its economy by the deep recession in the West, in particular in the US, its largest trading partner, is owed to two facts: the aggressive response by the state to the decline in the rate of economic growth and the rapid, but still not fully understood, restructuring of its economy. In 2008, Beijing moved decisively to prevent a sharp decline in GDP by injecting large sums of public funds into the economy. A stimulus package of RMB4,000 billion (US$585 billion) was launched largely to further develop physical infrastructure – roads, railways, airports, ports, bridges and tunnels. The money flowed from the federal budget to the state-owned agencies responsible for building and maintaining infrastructure. Beijing used more than public money to stimulate the economy. The authorities instructed the banks they controlled to dramatically increase their lending for both industrial development and domestic consumption. Banks lent a record RMB9,600 billion (US$1,524 billion) in 2009, bringing the total stimulus to US$2.1 trillion, three times the amount provided by the US. This amounted to an extraordinary 43.0 per cent of the GDP, which for 2010, was estimated at US$4.9 trillion. Even if this amount is spent over a period of three to four years, it will still amount to a significant boost by the public sector to the economy. This was perhaps the largest push ever given by the mangers of a large system to a faltering economy.

The stimulus money was spent quickly by bringing forward the projects that were already included in the current five-year plan or were at the planning stage. In fact, the authorities cut the implementation period of the current five-year plan to three years. Beijing's main concern was with rising unemployment. Some 20 million workers, mostly migrants from the countryside, were laid off by industries in the private sector that depended almost entirely on exports to the West. Under the Chinese system of human resource management, the unemployed workers were required to return to their villages. The Chinese were fearful that this return would make the countryside restive. Given the country's history, Beijing is always alert to the possibility of "peasant rebellions".

Having given up on *The Washington Consensus* sets of policies it had partially adopted during the first phase of the Chinese economic take-off, Beijing went in for a more state-directed-economy approach during the economy's "second rise."[26] The state is now playing an important role in helping to revive as well as modernise the economy and is using this opportunity to

[26] The term "second rise" is used in the context of revival of the Chinese economy from the Great Recession to underscore some of the major structural changes that were underway at this time. See Shahid Javed Burki, "The Rise of China: How it might impact the world", ISAS Insights, No 86, 6 August 2009. http://www.isas.nus.edu.sg/Attachments/PublisherAttachment/ISAS_%20Insights_%2080_21102009214442.pdf. Accessed on 31 March 2010.

restructure the production system. It followed the “picking the winners approach” once popularised by Japan, and the miracle economy of South Korea. Like those two countries, the Chinese are also working on building and modernising their economy by focusing on a few sectors. One example of this approach is the state’s intention to turn the automobile industry into a leading sector. The sector was a part of the stimulation package developed by the government to revive the economy. It was also helped by the government’s directive to the banks it controls to provide consumer finance. These measures resulted in soaring sales. In January 2009, the government reduced by one-half the purchase taxes on small vehicles. The move prompted a buying spree that lasted throughout the year and extended beyond small cars to boost sales of vehicles of all sizes. As a result, the number of car sales in 2009 rose by nearly 53.0 per cent to 10.3 million while total vehicle sales – including buses, trucks and the small commercial vans that powered much of the growth in 2009 – rose by 46.2 per cent to 13.6 million. This allowed China to go past America and become the leading global automobile market several years ahead of expectation. US cars and light truck sales were at 10.4 million in 2009.

The focus on the automobile industry was not the only major shift to take place in the structure of the Chinese economy. It also began to give up on low-skilled labour output moving quickly towards high-skilled and knowledge-intensive industries. Short of cultivable land, China is also letting its industry go vertical, producing finished products in high-rise buildings by importing parts and components that need land-using factories to produce. The rise of the “vertical economy” in China will have important consequences for its trading partners especially those that are land rich as well as those (e.g. Singapore) that produce sophisticated components for high value added products. These parts and components in Singapore and other high-tech centres in Asia are also produced in high-rise buildings. These economies have provided China the example of vertically organising its production processes.

The state’s return as a major player in the economy, massive investments in the building of infrastructure, replacing low-wage exports in favour of knowledge-intensive products, temporary incentives for boosting domestic consumption, and others are some of the elements in the fourth phase of China’s economic transformation. Will it succeed once again? Or is China going to experience a bubble? In all probability, the combination of orthodox and unorthodox measures will enable China to contain the inflationary pressures that appeared at the end of 2009.

Year-on-year inflation increased to 1.9 per cent in December 2009. However, during the year, prices declined during February to October and increased during January, November and December. What is worrying, however, is the pace of increase; from 0.6 per cent in November to 1.9 per cent in December. What would be China’s approach to tackle this problem? A bit of history in which the author was personally involved will help in understanding how far the

Chinese have come in terms of developing the tools of macroeconomic management and how they may proceed in the future.

In 1991, the author received a call from Zhu Rongji, a senior leader of China who went on to become the country's prime minister. He requested if the World Bank could advise him on the best way to deal with mounting inflationary pressures. The author was called in his capacity as the in-charge of the World Bank's China operations. Minister Zhu handled economic issues in the Chinese cabinet. The author assembled a team of five central bankers from several parts of the world including the head of the New York Federal Reserve Bank and the Governor of the Central Bank of Chile. Two meetings were held with Minister Zhu and his colleagues. The first was on basic information on the economic situation, in particular on price increases. The second had the expert team presenting its proposals. Beijing subsequently carried out an economic stimulus program aimed at increasing employment. This was as a follow-up to the Tiananmen Square crisis of June 1989. That program resembled to some extent what China did in 2009.

The author was familiar with the official Chinese interpretation of what went wrong in 1989 and why so many people were prepared to risk so much to confront the regime. The Chinese leadership in those days believed that much of the discontent had economic reasons. They largely discounted the Western view that this was a pro-democracy movement. High expectations had been created by Deng Xiaoping's policies that had, among other things, opened the Chinese economy to trade and capital flows. One consequence was the sharp pick up in the rate of economic growth. However, there was no corresponding increase in the level of employment, in particular for the educated. Much of China's growth at that time came from the low value added manufacturing sector employing unskilled workers. Students were unhappy and were prepared to come out on the streets and protest at having been ignored by the economy. This, they did that summer.

The official response was not limited to sending the army to Tiananmen Square to clear the place from protestors. This is what the world saw on television. Beijing also launched a program aimed at improving the distributive content of its growth policies. As it did to tackle the downturn produced by the Great Recession of 2007-09, the government in 1989 ordered state-controlled banks to lend large amounts of money for projects that had high employment content. One consequence of the action was a rapid increase in the level of prices which had an impact on the real incomes of the less-well-to do segments of the population.

At the time when the author took the central bankers to Beijing, the People's Bank of China was still in the process of converting itself from a quasi-commercial bank to a regulatory agency that controlled money supply and supervised the commercial banks. One purpose of the mission was to suggest how that process of transformation could be quickened and also what instruments could be used by the central bank to bring money supply under control. Macroeconomic management was further complicated by the fact that tax collection was in the hands of the provincial authorities. The centre received its share by negotiating with the provinces. Unlike other federal systems there were no agreed formulas for the sharing of revenues among governments at different levels. The expert recommendations, therefore, covered both the monetary as well as the fiscal sides of macroeconomic management.

This history is being mentioned to underscore how far China has come in terms of modernising its economy as well as the system of economic management. Even then, it is less advanced than several other large emerging economies. The state plays a much greater role and uses both direct controls and market operations to manage the economy. It is unlikely to continue to follow this approach for several more decades.

The over-heating of the Chinese economy is a matter of great concern for Beijing now. As in most other developing countries, there will be greater impact of inflation on the real incomes of the poor. Beijing is determined to act but will wait until it has more data to suggest that the economy is heating up. If that indeed happens, the authorities will move in two different ways. To paraphrase Deng Xiaoping, it will be macroeconomic management with 'Chinese' characteristics. The authorities will use monetary policy to reduce money supply. This is the standard approach most countries use in moments of stress. This was employed in the early 1990s as well. There will also be direct controls on expenditure. With more instruments available now for managing the economy, there will be greater emphasis on direct controls. There is a reason why the Chinese may want to go that route.

By increasing interest rates while the rest of the world, in particular the US continues to keep them low, would invite more capital flows into China and lead to further swelling of its large dollar holdings. This would increase the imbalances in the global economy that are generally considered to have caused the Great Recession of 2007-09. Beijing, therefore, will make a larger use of direct controls. It will send out strong signals to the banking sector, most of which it controls, to reduce lending especially for large projects and the purchase of consumer durables, particularly automobiles. It will also use the fiscal system to withdraw the incentives it had provided to consumers to purchase more durable goods. The provinces will also be told to reduce their development expenditures. Interestingly, the rate of inflation will increase pressure on China to revalue its currency since that will help to lower the prices of imported goods. This has been resisted by China but it may be a bit more accommodating this time around.[27]

[27] It is interesting to note that some Chinese officials may be getting ready to move on the currency front. According to one newspaper report, "Zhou Xiaochuan, governor of People's Bank of China used an appearance at the National People's Conference to give the clearest indication that Beijing is preparing to abandon the peg to the US dollar introduced in mid-2008. He told a press conference the currency peg was a 'special measure' to

One consequence of this large stimulus to the economy would be a significant increase in the share of the public sector in the Chinese economic system. This would reverse the trend of the last two decades when the authorities encouraged the state sector to shrink in line with the thinking that went under the nomenclature of *The Washington Consensus*. Initially the Chinese were apprehensive about downsizing the state sector since that would throw a lot of people out of work. However, a series of pilot projects launched in the northeastern states – the country's heavy industry belt – undertaken with the assistance of the World Bank persuaded the authorities that the people who lost jobs in the state-owned enterprises (SOEs) would find employment in the rapidly expanding private sector. This approach differed markedly from the one adopted by the countries that once made up the Soviet Union and those in Eastern Europe as they switched their ideologies from Communism to Capitalism. Communist Europe adopted capitalism by following the "big bang" approach. The Chinese, ever pragmatic, opted for the gradualist approach. Beijing changed course as it began to deal with the stress created by the Great Recession of 2007-09. Not fully trusting the private sector to keep on creating jobs during economic downturns, Beijing turned to the public sector to play a more aggressive role. Ministries and state-owned enterprises were given the means to employ tens of thousands of people, mostly recently unemployed, to build large infrastructure projects. One consequence of the way the Chinese handled the 2008 economic downturn was to interrupt this process of transferring workers from the public to the private sectors of the economy by creating space for them in the state sector. One unintended consequence of this will be to strengthen the role of the state in the economy, which will be used to handle the opportunities created and the problems posed by the extraordinary changes in the global economic system.

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help China weather the financial crisis. 'These kinds of policies sooner or later will be withdrawn'. After several months of tough talk from Beijing about not giving in to foreign pressure, amid accusations that its currency is undervalued, his comments were significant shift in official rhetoric." Geoff Dyer and Jamil Anderlini, "Hopes fade of rapid removal of peg to US dollar", *Financial Times*, 9 March 2010, p. 3.