Look to China's productivity gains, not headline growth figures

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James Laurenceson

China's economy grew by 7.3% during the third quarter of 2014, meeting market expectations.

Polling by Reuters and the Wall Street Journal put the consensus forecast at 7.2-7.3%, the slowest pace in more than five years.

But to see where China is really headed, a closer look needs to be taken at its productivity.

With iron ore prices already sitting at five year lows, a further slowdown in Chinese growth is not the sort of news that Australian policy-makers need. What is of greater concern is whether we are seeing the beginning of something more permanent. Will China have a similar trajectory to Japan since the early 1990s? This would impact the rise of China's middle class – conceivably growing by another 850 million by 2030. It is this middle class that is set to underpin demand for Australia's exports for decades to come.

In the long run economic growth is delivered when productivity climbs. That means finding better ways of doing things. The only other way to produce more output is to use more inputs. However, the problem is diminishing returns. Building a rail link that connects an inland city with a port brings enormous benefits but once built, there is little need for another.

This is precisely the problem that Nobel Prize winning economist Paul Krugman found confronted the Soviet Union in the 1950s and Asian countries such as Singapore more recently. It is also the big worry associated with China's current growth model which saw investment hit 47.8% of GDP last year, an extraordinarily high level.

Productivity struggles to attract the attention of commentators because it is hard to calculate. Professor Chris O'Donnell and I recently published some new estimates for China. Over the period 1978-2010 we found evidence of rapid productivity growth across most provinces. This is good news but also no surprise - China had access to easy sources of productivity gains such as borrowing technology from overseas.

The key question is whether productivity can continue to improve as the economy matures?

China has many of the basic policy settings right.

The government has spent much on human capital and the results are significant. In 2004, China had eight universities in the world's top 500 and none in the top 200. Just a decade on and the respective figures are 32 and six. China's universities are now second only to those in the United States in terms of their total research output.

But for truly rich productivity gains to be unlocked, reforms are needed that shift the economy away from its dependence upon investment. For consumers to take the lead they need more income. Getting state-owned banks to pay the household sector market rates of return on their savings deposits is one example of the type of policy that is sorely needed.

Delays to reform will be costly. In their latest country report released in July, the International Monetary Fund forecast that if needed reforms were swiftly implemented, China would grow at around 6.5% in 2020 and 5.5% in 2025. Without them, growth could fall to as low as 4% and 3%, respectively.

Facing a downturn in economic activity, the first instinct of China's leaders is to pull policy levers that pump up aggregate demand. But temporary measures to boost growth such as expanding the supply of credit have largely run their course and are no longer sustainable. Comments made by Premier Li Keqiang to the World Economic Forum in Tianjin last month suggest that China's leaders now understand this.

When pushed they have also shown themselves to be nothing if not pragmatic. President Xi Jinping's aggressive tackling of official corruption in response to public anger is a case in point. If stalled living standards are to be avoided, committing to a productivity-enhancing reform agenda is really the only option that China has left.

So don't get lost in the headline growth number. Focus instead on what the data says about the trajectory of productivity. Through the first half of 2014 consumption contributed 54% of GDP growth, while investment chimed in with 49% (net exports were responsible for -3%).

The overall growth rate may be disappointing but if there is a widening of the gap in favour of consumption then this is exactly the sort of news that China and Australia needs.

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