Chapter I

In Perspective: Long-Term Economic Growth

I.1. Consequences of China's Rise

The flood of books, papers and conferences on the subject of China's rise, and Asia's rise more in general, is hard to cope with. Stark titles and sub-titles seek to seduce would-be-readers. But is the rise of China and let us add India or even "Asia" (or "emerging Asian economies"), really such a new phenomenon? In the 18th and 19th century, beginning with the Netherlands, followed by Britain and most of the rest of Western European countries and the United States found the key to steady economic growth, as we take for granted today and which has allowed for a doubling of living standards in every one or two generations. Today's China hype reminds one of a similar hype surrounding the rise of Japan in the 1980s. Or a French outcry about "Le Défi Americain", published in 1973, according to which corporate Europe would be "eaten up" by American investors.

In a sense it is more surprising that it took so many countries so long to follow after Western economies took off. Whatever the underlying historical explanation for this "delay", it led some observers to believe that stagnation and lasting poverty was the inevitable fate of the majority of Asia and Africa ("coloured people"?). It was even argued that protestant religion and culture made (white?) people better equipped to develop capitalism and build thriving economies. Singapore's Kishore Mahbubani touches at it in his "Can Asians think?".[6] In spite of this catchy title, the issue he really addresses in

[6] Kishore Mahbubani, Can Asians Think?, 2004.

the essay from which his book derives its title is not if Asians can think, but if they can achieve the same level of welfare as the West. His answer is a clear "yes".

And we are getting that same answer every day now from Asia: yes, Asians can "think", or rather: Asians are very well able to improve their living standards. And why would they not? Until 1750/1800, before the West set of to an economic growth spurt that would last until today, China and India between them accounted for some 50 percent of world GDP. Subsequently, China, which had very much closed its economy from foreign trade and culture, saw *relative* decline against the background of the technology driven productivity growth and rising income levels in the West. This didn't improve after the West, in 1842, forced China to open up and participate in the international trade game as dictated by the West. At that same time, India's economy grew by an estimated 0.5 percent per year, until 1948.

Japan had already in the 19th century found the "key to growth" and modernisation. In the 1950's and the 1960's the Asian tigers, Hong Kong, Korea, Singapore and Taiwan followed. China first went through its devastating "Great Leap Forward" and the chaos of the Cultural Revolution, but in 1978 it, finally, found the key too, followed by India in 1991. I use the word "key", because the study of economic development makes economic growth almost look like a door that can be opened, a light that can be switched on. Put the right policies in place and off you go. Telling is the story of Chinese leader Deng Xiaoping who, in 1978, visited Thailand, Malaysia, Korea and Singapore to see "how they did it". Back in China, he just switched China's growth machine on, as it were. Deng turned the page and set China on a path of uninterrupted growth for the next three decades, lasting until today.

Before looking into greater detail at the rise of China and its consequences for the West four remarks are in place. First, as I said, I believe that China's rise (apart from its size, a point which is hard to neglect) is no different from the rise of dozens of countries whose economic rise started centuries or decades before — or at least less different than many want us to believe. Second, in spite of their strong growth performance in the last decades and in spite of great improvements made, both China and India are still very poor countries today with hundreds of millions in deep poverty. China's average standard of living is some 20 percent of living standards in the EU, India's no more than 10 percent. There is great income inequality in both countries. Third, the one factor that makes the rise of China and India so special is the sheer size of their populations, 1.3 billion and 1.1 billion respectively. China and India account between them for 36 percent of the world population. If one adds up the 500 million living in the ASEAN countries,[7] part of which are also catching up very rapidly, the number becomes 2.9 billion, 44 percent of the world population today. Hence their rise inevitably has a huge impact, also for the rest of the world population. Fourth, this latter aspect, population size, becomes particularly telling and of an impact when one thinks of the consequences for the environment and the pressure on scarce resources.

When at New Delhi's Auto Show, in January 2008, the Nano was presented — India's T-Ford or Volkswagen Beetle — with a price tag of USD 2,500, the world watched in awe, but not without concern. What if millions of Indians start driving this cheap car, how about the impact on the environment? The same can be said for the aspirations of China's 1.3 billion. What if China's 1.3 billion will all have electricity, will be able to buy fridges and dishwashers, drive cars and eat more meat? China's car park is growing by 5 million per year and that growth will accelerate, every year. Already today we can feel what China's growth means for the environment and prices of oil, copper, steel and other resources.

The race for bio-fuels and the competition over carbon hydrates between people's stomachs and their cars have added another aspect to the calculus which has helped set food prices on a steady rise. Unless adjustment takes place, policy measures are taken and new technologies developed the pressure can only increase. We are probably only seeing the beginning of this new environmental challenge and renewed competition for alternative uses of resources. Trade and investment questions will pale in comparison as they will pass

[7] ASEAN was established in 1967; Member States today are Brunei, Cambodia, Indonesia, Philippines, Laos, Malaysia, Burma/Myanmar, Singapore, Thailand and Vietnam.

Share in world Gross Domestic Product (GDP), at 1990 international USD and average GDP per head

	China	India	Asia (excl. Japan)	Western Europe	USA
Share and per head, 1820	32.9% 600	16.0% 530	56.2% 575	23.6% 1230	1.8% 1260
Share and per head, 1913	8.9% 550	7.6% 670	21.9% 640	33.5% 3470	19.6% 5300
Share and per head, 1950	4.5% 440	4.2% 620	15.5% 635	26.3% 4590	27.3% 9560
Share and per head, 1998	11.5% 3120	5.0% 1750	29.5% 2940	20.6% 17,900	21.9% 27,300

***Source*:** Maddison, The World Economic Millennial Perspective.

in the same way as the Japan hype of the 1980's has blown over. Who is worried about competition from Japan today? Japan has smoothly integrated into the international economy and among others enabled us to drive its excellent, environmentally relatively friendly cars.

I.2. Asia: Finally Getting There?

The debate around the rise of China — and along with it India and other emerging economies in Asia — is overly excited, reminiscent of the exaggerated assessments when Japan was growing at break-speed 25 years ago. A common notion is also the suggestion or prediction of a decline of the West and the disappearance of jobs in the West. Apparently many in the debate have hardly bothered to take time to reflect on or look at similar examples of sudden bursts of economic growth in the past.

The economic rise of the United States in the second half of the 19th century and its continuation in the 20th century have led to a significant change in the balance of power in the world; that is worth to reflect on. But, for instance, the standard of living of British citizens and British national income, and also that of other nations, while becoming *relatively* less important, has only increased and is still increasing. In spite of and possibly precisely because of America's economic rise people in Britain were better of in 1875 and in 1900 than they had been before and since then their living standards have, once again, improved tremendously. The increased economic power of the newcomers should of course be reflected in their representation in international bodies. The existence of the so-called G-8 in its present form (including Canada and Italy as members, but without China) is an anomaly which should be corrected.

At the time I write this, in early 2008, both EU and US policy makers lament about the bilateral trade deficits they have with China. But the EU, in spite of its bilateral trade deficit with China of 250 billion euros in 2007 has a positive trade balance and a balanced current account balance with the world as a whole. The deficit with China is compensated by surpluses with other trading partners. In the first half of 2008, unemployment in the EU was at a 25-year low. Could it be that cheap inputs from China keep the EU economy ticking and that the EU has little to worry about?

Let me reiterate that one particular aspect makes the rise of China and India special: the sheer size of these countries in terms of population. China and India together have a population of 2.4 billion, 36 percent of the world population of 6.6 billion. The EU and the US together account for 800 million people, 12 percent of the world population. The rich economies together, account for some 15 percent of the world population. At the same time, in spite of rapid economic growth in China and India and in spite of the fact that hundreds of millions have been lifted out of dire poverty, many of their people are still poor: hundreds of millions in these countries still live in poverty. In other words: more and continuous growth is still needed in these countries.

Is there really reason to worry and lament for the West about the "competitive threat" when we see how these countries, first, may in fact contribute to our wealth (see the reference in Footnote 3 on page x) and, second, finally have found out how to climb up the ladder and reach living standards somewhat closer to, albeit still much lower than those in the West? Once again, a more interesting question is why it took these countries so long to find the key to greater prosperity. Is there something mysterious in why and how economies grow?

I.3. China's Rise in Perspective

It may be useful to remember how relatively young the phenomenon of economic growth as we know it and have got accustomed to is — i.e., the steady, significant annual rise of economic productivity and output per worker, only interrupted by brief periods of recession. That pattern, that we are now so used if not addicted to, has existed for only a little more than two centuries. Until the second half of the 18th century slow economic progress with an annual growth of no more than half a percent per year, was the norm, just enough (or not enough) to keep up with population growth. It brought Thomas Robert Malthus (1766–1834) to his theory that economic growth would never be able to keep up with population growth and that therefore in the long run impoverishment and famine would be inevitable.

According to data constructed, over many years and from many sources, by Angus Maddison — the guru of long-term economic development — up until somewhere around the year 1800 the economies of China and India combined accounted, for many centuries, for close to 50 percent of world gross domestic product (GDP). Today their combined share of the world's annual economic output is somewhere between 15 percent and 20 percent, the best guess is 17 percent. But that is after three decades of very high growth in China and sixteen years of accelerated growth in India; after a long "recovery" of these two giants from the time, in 1950, that they accounted jointly for no more than a meagre 9 percent of the world's GDP.

This declining *share* is mostly explained by the rapid *rise* — economic growth — in other parts of the world, not by an *absolute decline* in China or India. In a long term perspective all areas of the world have seen some economic growth in the last two centuries. But, for instance, during the period 1820 to 1952 the Chinese economy grew by a mere 0.2 percent per year, less than the rate of population growth.

During that same period annual economic growth in the US was 3.8 percent, in "Europe" and Japan 1.7 percent and in Russia 2 percent. So whereas China and India stagnated in the period between 1800 and 1950 other parts of the world saw a rapid growth rally. What we see today is therefore not more than *China and India finally catching up*.

Against the backdrop of the rapid economic expansion in the US, Europe, Japan and the Soviet Union/Russia after 1800, China and India seemed, until 30 or 25 years ago, lost cases in economic terms. Since then, first, China has seen very rapid economic growth. And now also India is reporting growth rates nearing 10 percent per year. In a way these two countries are emerging after a long-term slump. Probably it is today's best economic news. Thanks to China's phenomenal growth of the last two decades, millions have been lifted out of poverty. The estimates are between 400 million for China and 300 million for India, more than could have been achieved with any aid programme, whatever its scale.

Until a few years ago there was suspicion that China inflated its growth figures for propaganda reasons, that growth was in fact lower than reported. Gradually Western observers started to believe the Chinese figures. In 2005, the results of a business census led to China to revise its GDP upwards by as much as 17 percent. Chinese statisticians literally "discovered" a vast amount of economic activity that had been going on without statisticians noticing it. The main reason was that China's communist past made its statistical system better equipped to measure "hardware", tons of steel and butter produced, than "software", mostly activities taking place in the services sector, such as economic output in the form of haircuts, retail activity or tourism.

However, in spite of this high growth and all the hype *China is still a poor country*. Per capita income in purchasing power parities (PPP)[8] — i.e., what one can buy for one's money, the "standard of

[8] PPP = not using exchange rates only, but also taking into account differences in price levels between countries, accounting for the fact that 100 euros buys more eggs or shoes say in China than in the EU.

living" — is at best 20 percent of the EU average and by consequence some 14 percent of the US average. Living standards in India are on average something like 10 percent of those in the EU, 7 percent when compared with the US (and possibly lower). Rapid economic growth in China has led to calculations predicting — or speculating — when the Chinese economy may be "overtaking" the US economy. Some put this event at 2025. Extrapolating today's growth rates suggests that the Chinese economy could "bypass" the US economy somewhere around 2040 and much earlier even if we take purchasing power parities as the basis of our calculation.

But what does "bypassing" or "overtaking" mean? Today there are 1.3 billion Chinese and 300 million Americans. If we assume, on the basis of population growth rates, that there will be three times as many Chinese as Americans in 2040, "overtaking" would only mean that, ***on average***, the Chinese would have reached a level of welfare ***one third*** that of a US citizen (by then). By the same token (and at present trends), China's average welfare level might be somewhere around half — with a little luck more — that of the EU. On the scale of EU today's standards of living "ladder" China might be somewhere where Poland is today (67 percent of the average of the EU of 27). We can only hope for better living standards for the people of China and India — and for ourselves.

Has the rise of the US and American prosperity in the 19th and 20th century been a threat to Europe? The answer that makes most sense in economic terms is: no, probably not, probably to the contrary. One can say the same for Japan's rise. And the same will apply, once again, for the rise of China and India. The "recovery" of China and India should not make us believe that their gain is our loss. Has the West not told dozens of poor countries, time and again, that globalization, international trade and competition are a win-win game?

The West can only hope that China and India will manage to reach one day — still decades away — average levels of prosperity that today the majority of EU citizens take for granted. That would be good for them, but also for us. It will mean that the EU's relative share in world GDP will shrink. But the issue, the challenge for the

EU is: levels of productivity and GDP within the EU. The challenge for Europe (and the US) will be to get its own economic act together, which means that Europe and the US should further improve education, research and development and infrastructure to maintain steady productivity growth and ensure continued growth of their economies.

The time of writing is early 2008 and the world, or economists of the world at least, look in awe at China's economic growth figure for 2007: 11.4 percent. In spite of increasing concern about decline in the US, China's GDP is expected to grow by another 10 percent — 9 percent at least — in 2008. True, rising inflation (5 percent in 2007 and rising to 10 percent at least in 2008) is a concern. How about India? Not exactly the same, but also there has been very high growth, most probably once again something like of 8.5 percent and 7 percent at "worst".

As said, the US economy was expected to slow in the course of 2008 and seemed to be sliding into recession, which was to affect the economies of China and India and of other countries too. In particular China, with 20 percent of its exports going to the US saw slower growth. But then, yes, the economists tell us, slower growth in the US may shave off 1 percentage point, perhaps even 1.5 from growth in these two countries in 2008, which would imply that these two growth machines would end up with say a "meagre" 9 percent or 8 percent growth of their economies in 2008, which is still spectacular. Supposing that this assessment will prove to be correct, this would form demonstration of the strength of these economies.

I.4. Long-Term Growth: Where Does It Come From?

The most intriguing question remains where this economic growth comes from. The simple, but not very helpful answer, is given by Mancur Olson in an article in Economic Perspectives. In short, it is "sound economic policy":

> Since neither differences in endowments of any of the three classical aggregate factors of production nor differential access to technology

Basic comparative data, 2007 (unless indicated otherwise)

	China	EU	India	USA	World
Population in bln. (in brackets % of world pop.)	1.3 (20%)	0.5 (7.5%)	1.1 (17%)	0.3 (4.5%)	6.7 (100%)
Infant mortality per 1000 live births	21	6.4	32	6.3	42.0
Life expectancy at birth	73	77	69	78	66
GDP (PPP, see footnote 6) trln USD	8.0 (12%)	14.4 (22%)	3.0 (5%)	13.9 (21%)	65.8 (100%)
GDP, PPP/per head, USD; in brackets: % of world average	6,150 (61%)	33,000 (330%)	2,700 (27%)	46,000 (460%)	10,000 (100%)
GDP at exchange rate, trln. USD	2.9	16.6	1.1	13.8	54.6
Income distr. (Gini)[9]	47	30	37	45	
Exports, % GDP	42%	9%	16%	8.2%	25%
Exports, trln. USD % world exports	1.2 (8.6%)	1.3 (9.4%)	0.15 (1.0%)	1.14 (8.1%)	13.9 (100%)
Electricity production, trillion KWh	3.2	3.0	0.67	4.0	18.6
Electricity production/head, KWh	2,500	6,000	610	13,300	2,770
Cell phones per 1000 population	385	950	150	785	310
Internet users per 1000 population	125	500	54	690	150
Automobiles, mln	30	230	12	240	
Automobiles/1000	23	460	11	800	
Military expenditure, % GDP	4.3%	2.0%	2.5%	4.5%	2.0%
CO2 emissions, 2004, (million metric tons and % of world total	5,000 (17%)	4,000 (14%)	1,300 (4.5%)	6,200 (21%)	29,000 (100%)
CO2 emissions, 2004, tonnes per capita	3.8	8.1	1.2	20.6	4.4

Source: CIA World Factbook with some own estimates.
trln: trillion; mln: million.

[9] Zero means there is no income inequality: everybody receives the same; 100 = 100 percent inequality: one gets all.

> explain much of the great variation in per capita incomes, we are left with the second of the two (admittedly highly aggregated) possibilities set out above: that much the most important explanation of the differences in income across countries is the difference in their economic policies and institutions.[10]

Olson leaves us empty-handed as he doesn't give us an insight as to which economic policies to follow with his tautological "advice". Elmahan Helpman is more explicit by listing elements that an economic policy for growth should contain. In order to achieve economic growth, Helpman argues, a country needs *productivity growth* — but that is rather a statement of the obvious. Admittedly, he elaborates on the drivers of this productivity growth: innovation fed by research and development, subsequently the accumulation and diffusion of knowledge, trade and other exchanges (e.g., of technology) and, finally, again the less tangible factor "institutions and politics" although the latter are specified by the key expressions property rights, rule of law, limits on the power of rulers.[11]

In her "The Elephant and the Dragon" Robyn Meredith describes how, in 1978, Chinese leader Deng Xiaoping, aware that China had to modernise, visited Bangkok, Kuala Lumpur, Seoul and Singapore to see how modernisation worked. Meredith says the following about Deng's meetings with Singapore's Lee Kuan Yew:

> The two men held three days of talks, and as Deng toured Singapore, he found a modern, technologically advanced nation suitable as a model for China's development. "That journey was an eye-opener for him," said Mr. Lee decades later, "a turning point". It was indeed, both for Deng and for China. The ethnically Chinese city-state of Singapore was, and remains, famous worldwide for its stable, one-party rule and its lack of freedoms (…) as well as its remarkably rapid transformation from a developing country to a modern, capitalist one. The government heavily planned Singapore's economic development, building modern

[10] Mancur Olson Jr., "Why Some Nations are Rich, and Others Poor", in The Journal of Economic Perspectives, Spring, 1996.
[11] Elhanan Helpman, The Mystery of Economic Growth, 2004.

> infrastructure and attracting foreign investment. Pro-business policies made the city an export powerhouse and quickly raised the standard of living of its people. China's attitude adjustment was radical and immediate.

The quote once again suggests that the key to economic development is just there to grab and open the door.[12] The path is not necessarily the same for all countries and there is no standard policy recipe. China certainly did not follow the standard recipe recommended at the time, which was to move quickly. It chose a gradual approach, no sudden shock, and decided to give economic reform priority and leave political reform out of the equation. But both China and India put great effort at improving education, putting research and development high on their agenda, introducing principles of market economics and, possibly a more mundane purely economic criterion, both ensured sound fiscal and monetary policies. So in a way the changes beginning with China in 1978, after the country's bankruptcy following the Cultural Revolution, and in India, after hesitation, but under the pressure of untenable external financial constraints, boils down to the political leadership "simply" turning the page and deciding (choosing) for a new policy.

I.5. Seven Pillars of Western Wisdom and the Soft Infrastructure of Capitalism

Kishore Mahbubani, reviewing the growth drivers in the particular case of Asia, defines what he refers to as the "seven pillars of Western wisdom": "The Japanese learned well: they found — as the four tigers found a century later, and China and India have realized during the past two decades — that there were at least seven pillars of Western wisdom that could have an almost *miraculous* (emphasis mine) effect on their societies." Those seven pillars are, according to Mahbubani: 1) free

[12] Henri Ghesquiere in "Singapore's Success" (2007) refers to it as "the seemingly secret key to unlocking the potential"; the subtitle of his book is, very appropriately, "*Engineering* economic growth" (emphasis mine).

market economics; 2) science and technology; 3) meritocracy; 4) pragmatism; 5) culture of peace; 6) rule of law and 7) education.[13]

One may wonder whether the inclusion of the "culture of peace" in this equation, welcome as it may be, can be justified. Does this not overlook the fact that Europe has seen devastating wars in the last century, which although interrupting its long-term growth spurt have not halted it? We may of course take a shorter term view and consider Europe's change of mood and mind with the creation of the European Union and the EU's "soft power" and active support to multilateral institutions in the second half of the 20th century as more characteristic than this previous experience.

Still, speaking about "the West" there remains a big question mark over this "peace pillar" when one considers the export of violence by the US. One doesn't have to be a fan of Naomi Klein and believe in the distorted picture she presents of a US conspiracy in the name of Milton Friedman in practically everything the US has been doing abroad in the last decades,[14] to acknowledge that there has been a considerable amount of exported violent action and warfare by the US.

The US figures number 97 on the "Global Peace Index" and between 1989 and 2001, the United States intervened with force in foreign lands more frequently than at any other time in its history — an average of one significant new military action every sixteen months — and far more than any other power in the same stretch of time. This expansive, even aggressive, global policy was consistent with American foreign policy traditions."[15] There may be a wish and a theory of preaching peace, but how credible is that when practice is so different? One may easily argue that at present the US is the most aggressive nation on the globe.

How about democracy? Is democracy not a pre-condition for steady economic growth? Do we not at least hope or believe it is?

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[13] Kishore Mahbubani, The New Asian Hemisphere, 2008.
[14] Naomi Klein, The Shock Doctrine, 2007.
[15] Robert Kagan, The Return of History and the End of Dreams, 2008.

According to UNDP data, among the 25 richest economies in the world in 2007,[16] 23 can be qualified as open democratic societies (to be noted: Italy, which I count among the democracies, is by the Economist Intelligence Unit (EIU) ranked as a "flawed democracy").[17] The two small city economies of Singapore and Hong Kong, which complete the 25, may be seen as "special cases". Among the next 25 on the list of richest nations, the numbers 26 to 50, there are no more than seven democracies, 14 "flawed democracies" and four "authoritarian regimes". Of the 25 poorest nations of the world according to UNDP 15 are listed as "authoritarian regimes by the EIU, 8 as "hybrid regimes" and a meagre two as "flawed democracies". So there seems to be some relationship at least between prosperity and democracy, but the question is: how does that relationship work? Does democracy come with (as a result of) prosperity or does a country need democracy to grow — or, more accurately, to *be* rich?

Democracy may come in many forms and shapes and democracy as the West considers as normal and the norm today and as the EU and the US seek to promote or "export" is a relatively new phenomenon — as is the rule of law. When it comes to the question of democracy and China it should be acknowledged that China's citizens enjoy much greater freedom today than they did two decades ago, but China is not a democratic state or a "free democracy". Its own leaders recognise that. But then, again, is democracy not a pre-condition for growth, as many in the West think or wish to think? Peter Nolan thinks it is not; comparing transformation in China and Russia he writes:

> Hardly a single country has grown from low to high income in a democratic framework. Contrary to popular belief, none of the advanced economies had mass democracy in the early stage of modern economic growth. During the take-off phase virtually all of them were governed by liberal principles which granted political rights to

[16] GDP/PPP data in UNDP: "Human Development Report, 2007/2008", on http://hdrstats.undp.org/indicators.

[17] www.economist.com/media/pdf/DEMOCRACY_TABLE_2007_v3.pdf

> property holders, but did not mostly allow political power to be granted to the urban or rural proletariat, to impoverished racial minorities or women. The development of mass democracy *followed* (emphasis mine) rather than preceded the take-off. This has been the case too in successful industrializers in the late twentieth century.[18]

So, on this account and it seems difficult to refute it entirely, democracy should rather be seen as the *product* of growth, the *consequence* of greater prosperity. Another sobering reminder that democracy is a relatively new phenomenon comes from Larry Diamond of the Hoover Institution: "In1900 there was not a single country in the world that would qualify as a democracy by today's standards. As of January 2000, there were 120 democracies, the highest number in the history of the world".[19]

Perhaps it makes sense to qualify "democracy" and to use Will Hutton's expression "the soft infrastructure of capitalism", a notion he extensively elaborates on in his "The Writing on the Wall".[20] Elements of Hutton's "soft infrastructure" are, for instance, civil society — from religious organisations to Green Peace and from School Parents Committees to labour unions and consumer organisations, but one may also think of professional guilds for instance in 18th century Europe, media including critical media, books (Dickens, Marx, Engels), property rights and a properly functioning judiciary.

Hutton sees these "institutions", developed during enlightenment, part of them well *before* political democratisation, all as an important, if not indispensable factor, counterbalance and corrective mechanism to market forces. Civil society organisations and media have been indispensable in drawing the attention to poverty and health hazards in what are rich democracies today, enabling corrective action already before there were electoral democracies in place. Some of these factors — as said: part of the tissue of society before full

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[18] Peter Nolan, Transforming China, 2004.

[19] Larry Diamond, A Report Card on Democracy, Hoover Institution, www.hoover.org/publications/digest.

[20] Will Hutton, *The Writing on the Wall*, 2006.

democratisation — are not present in today's China. So will China be able to generate necessary corrective action where needed?

Income disparities and environmental destruction are among the most serious of China's growth pains. China's political leaders are aware and seek to reduce and correct these pains. It remains to be seen, however, whether China's top-down approach with which it seeks to remedy these pains is sufficient without Hutton's "soft infrastructure" providing feedback and counterbalance. China may have learned important lessons from Singapore and have prospered on the basis of those lessons, but Singapore's population of 4.3 million may make it a special case (like the small European growth "tigers" Ireland, Estonia and Luxembourg are cases of their own).

It may be easier to govern small-scale Singapore in semi-authoritarian style, as a family as it were, than China, the most populous state on earth. For Singapore's rulers it may be possible to receive direct feedback from its 4.3 million people, living on 630 square kilometres, and apply appropriate corrective measures. *Mutatis mutandis*, for China's rulers, who are in charge of a country of 1.3 billion on 10 million square kilometres, this may be a much more complicated matter. This leads in the case of China to the question not whether *greater* democracy, or soft infrastructure of capitalism, is *desirable*, but whether it may be *required* to make China's economic growth sustainable. On the basis of the experience of rich nations (see quote from Nolan above) one may reason that it is open to question at which income level democracy (or greater democracy?) is needed. And perhaps sustainable growth can be achieved by the *gradual* introduction of democratic principles (as it was in fact the case in many Western countries).

One may also consider China's reform process versus India's. In the case of India it is often claimed that as India is a democracy, it can be more complicated to implement reforms there than in China. Ironically, there are examples where India's Communists blocked the government from implementing reforms the Communist regime in Beijing was able to go ahead with unhindered. Nolan reminds us of the scepticism that existed among both Western economists and within China's Communist Party itself with regard to China's reforms. It was argued that democracy and privatisation were preconditions for long-term economic growth whereas in China the party remained firm in control:

> The fact that the Chinese system of political economy in the 1980s was "market socialist" and yet was one of the most dynamic in terms both of output and income growth that the modern world had seen, presents economists with a puzzle: why did it perform so well in the first decade and a half of reform, despite the fact that the economic institutions were gravely inadequate in relation to mainstream Western economic theory and policy? (…) A more worrying possibility is that China's incrementalist approach to economic reform may have been correct and the attempt in most of Eastern Europe and in the former USSR to move rapidly towards a market economy may have been a serious mistake.[21]

Nolan suggests that there may have been a "huge inherent catch-up and overtaking possibility which may have been latent in all former Stalinist economies on account of the vast under-performance in relation to their huge physical and human capital inheritance." In reply to this it can be pointed out that the former Soviet Republics in East Asia, who haven't followed a standard textbook quick-fix solution either, are still poor and non-democratic today whereas the East European former Satellites, in particular Poland, have gone the whole way from rapid "shock therapy" and impoverishment initially to normalcy today, including improved and further improving living standards and democratic regimes.

Poland and other former communist states that have joined the European Union in the meantime have returned to "normalcy" relatively quickly. These countries turned into democracies at an early stage of the transformation process and later in the process their economies started growing again, admittedly, all of them after initially seeing large falls in output. The prospect of joining the EU influenced

[21] Peter Nolan, *Transforming China*, 2004.

the transformation process and not least the predictability of the transformation and hence how economic prospects were perceived, among others by investors, including foreign ones.

What can be said in the case of China is that in spite of China's impressive growth performance so far, it remains to be seen whether China once it reaches middle-income status will be able to maintain today's balance of the "socialist market economy" with its firm one-party rule. As I pointed out, the question is raised within the Chinese Communist Party (CCP) itself. Recently it was addressed in a report by the Party School in which it is argued that greater freedom is indispensable for the Party to maintain its legitimacy and stay in power.[22]

I.6. Democracy and Indicators of Good Governance

The West strongly feels that (greater) democracy in China is desirable. The EU has active dialogue with China ongoing on human rights. One of the very modest wishes on the EU list is that China finally ratifies the UN Covenant on Civil and Political Rights (UNCCPR), which it signed in 1997, but so far China is holding off. The EU urges China to revise its penitential system and its approach to the death penalty. Both the EU and the US plead for the freeing of specific prisoners, not least those involved with the Tiananmen incident in 1989 who are still detained. The advent of the Olympic Games in Beijing in the summer of 2008, is leading to increased scrutiny of China's human rights situation by international media and the public alike. China is not impressed, but expectations are rising and tension is increasing. In March 2008, the situation in Tibet exploded, spreading to neighbouring Sichuan. Could there be more unrest, in other areas too? The Chinese authorities do not make an effort to pretend that China is a democratic state in the Western

[22] "Storming the Fortress: A research report on China's political system reform after the 17th party congress", in the *Financial Times*, 20 February, 2008:... "leading scholars have recognised the need for formal checks on the party's power, both through a strengthened legal system and freer media".

sense. They stress the very considerable improvements in the rights of China's population over the last decades, which are undeniable, and make two further points.

First, the Chinese leadership does not have the intention to introduce Western style democracy in China. Second, yes, there will be greater freedom for Chinese citizens, but only once the climate is ripe. This debate is, again, about the *wish* (above all, of the West) to have (greater) democracy in China. As we saw, within China's Communist Party discussion is ongoing about the possible *need* to introduce greater democracy. This less for reasons of principle than of pragmatism and on the basis of the assumption that some time somehow China's citizens will want to have a greater say.

The Chinese leadership has started releasing figures of demonstrations and riots that take place. In general and leaving aside Tibet, these demonstrations are typically triggered by corruption by local officials, cases of excessive pollution or the infringement of property rights or the right to continue to *use* land or housing. In particular the latter can be seen as "a test of the potential for political activism among the new middle class, especially residents of the wealthier cities who have acquired their own property" and "These protests suggest there could be limits on government ability to pursue big projects in urban areas".[23] Construction works for the Olympic Games have led to many evictions, leading to protests. The CCP is aware of the risks involved and thinking of ways to channel public anger — think of Hutton's "soft infrastructure of capitalism".

The question whether countries *need* democracy to *grow* is in a general, academic way dealt with by Przeworski and Limongi (P&L) in their little jewel "Political Regimes and Economic Growth".[24] I term it a jewel because the authors so clearly refuse to take any "conventional wisdom" for granted. They begin by pointing out that "while everyone seems to agree that secure property rights foster growth, it is controversial whether democracies or dictatorships better

[23] "Friction suspends work on Shanghai maglev", *Financial Times*, 7 March, 2008.

[24] Adam Przeworski and Fernando Limongi, "Political Regimes and Economic Growth", in *Journal of Economic Perspectives*, Number 3, 1993.

secure these rights" and continue with "*The idea that democracy protects property rights is a recent invention, and we think a far-fetched one.*" (emphasis mine). P&L remind the reader that the economic consequences of democracy were at the centre of debates concerning the rights to vote and to organise during the first half of the nineteenth century. Conservatives and socialists — as for the latter, including Karl Marx — agreed that "democracy, specifically universal suffrage and the freedom to form unions, must threaten property." The authors have bothered to compare 18 studies on the subject by other researchers, resulting in the comparison of 21 samples of countries during certain periods. P&L draw the following sobering conclusion from this:

> Among them (note: these 21 findings), eight found in favour of democracy, eight in favour of authoritarianism, and five discovered no difference. What is even more puzzling is that among the 11 results published before 1988, eight found that authoritarian regimes grew faster, while none of the nine results published after 1987 supported this finding. And since this difference does not seem attributable to samples or periods, one can only wonder about the relations between statistics and ideology. For reasons discussed below we hesitate to attach much significance to these results one way or another. Hence, we still do not know what the facts are.

To be fair to the studies that are compared, P&L do not mention the possibility that the more favourable outcome for democracy in more recent research could be related to the fact that, as I found, the more recent studies span periods which, unlike what P&L state about sample periods, on average end in 1988, whereas those where the conclusion is that authoritarian regimes are better for growth end on average in 1980, i.e., earlier. So the more favourable outcome for democracy *may* be the reflection of the fact that democracy has been (or was) "on the winning hand" rather than of researchers' "ideology" (as P&L suggest).

It is a sobering conclusion nevertheless, for a reader in 2008, almost two decades after the collapse of the Soviet Union and the fall of communism in Eastern Europe and after a period of a triumphant mood in the West about “the victory of capitalism”, which led even to a short-sighted, infantile and short-lived belief in “the end of history”. Today, many may have forgotten (even never heard of) the shock and concern the launch of the Sputnik by the Soviet Union in 1957 caused in the West. The fear was that the West might be “overtaken by the Soviets”. Today’s Western reader may indeed take both democracy and its supposed positive effect on economic growth too easily for granted.

We should, however, not forget that the P&L study is about democracy and economic *growth*, not the *level* of income achieved. There remains the fact that the 25 richest economies of the world today are predominantly democracies and none of the 25 poorest are. So, again, should democracy then perhaps be seen as the *product* of growth rather, the *consequence* of greater prosperity? Can one imagine today a rich country with a well-to-do middle-class, which is not at the same time a fully-fletched competitive, electoral democracy with free-speech? Singapore is perhaps the one and only example one can come up with.

William Easterly produces a table showing how democracy increases with income (or the other way round, the causality is not clarified). A bar chart for four groups of countries is shown: from “quarter least democratic” to “quarter most democratic, with average income levels (in 2002) represented as bars, gradually rising from 1,000 USD on average in the first group to 15,000 in the fourth. Easterly provides, however, no further explanation or the basis of his selection of countries and calculations.[25]

A graph on the subject in Henri Ghesquiere’s (HG) “Singapore’s Success” is more transparent. HG, ranks countries by their degree of democracy (according to “Freedom House”) on a scale of 1 (low) to 7 (high) on the horizontal axis and plots their GDP/PPP on the vertical axis. His graph shows, first, that the statistical relationship is a weak one at best; and, second, that only countries scoring a 7 (highest) for

[25] William Easterly, *The White Man’s Burden: Why the West’s Efforts to Aid the Rest Have Done So Much Ill and So Little Good*, 2006; page 130.

democracy are on average in a clearly higher income group than the rest. But then again, as HG points out “the direction of the causation is not self-evident”.[26] So do we have an answer now to the question whether China *needs* democracy to continue growing? No, we don’t. At best we may conclude that as China climbs the economic ladder the chances for greater democracy will improve.

Today’s wisdom is that *institutions* are crucial for ensuring growth. With the valuable and highly interesting World Bank governance indicators countries are given scores on six criteria 1) regulatory quality; 2) government effectiveness; 3) rule of law; 4) control of corruption; 5) voice and accountability (say, “democracy”) and 6) stability. In a chapter in *Dancing with Giants*[27] Philip Keefer seeks to match China’s and India’s impressive growth performance with these criteria. It appears, however, that both China and India score not more than average on these governance indicators. India, not surprisingly, scores higher than China on “voice and accountability whereas China does better on “government effectiveness”, also not a surprise. So how to explain that China and India combine impressive growth performance with such mediocre governance scores? Keefer, rightly pointing out that this is a “puzzle”, first argues that China’s and India’s scores although modest are still better than those of poorer countries. It is a good reminder once again, that on any measure and in spite of their strong growth both China and India still are poor countries on average.

In his further effort to understand and explain the “puzzle” Keefer introduces market size as an *additional* explanatory factor. That market size matters or may matter has often been argued and would be difficult to deny. Market size can help manufacturers to build up capacity and create economies of scale in the home market before starting to explore export markets. The argument has been used for explaining America’s growth and prosperity, arguably the clearest example.

[26] Henri Guesquiere, Singapore’s Success, 2007, page 158. On more than once occasion the author points at Singapore’s position as a “statistical outlier”, an exception to the rule.
[27] Philip Keefer, “Governance and Economic Growth”, in *Dancing with Giants*; editors L. Alan Winters, Shahid Yusuf, World Bank, 2007.

The market size argument has been used in Europe, to stress the importance of integration into one large market. It was the key argument for Europe's "1992" internal market exercise.

And there is abundant evidence that the size of China's domestic market has been a factor in attracting foreign capital. However, true and valid as the "market size" argument may be, it was not part of the initial equation, i.e., the "good governance explains it all" paradigm. Furthermore, China and India were already large markets long before they started growing rapidly in 1978 and 1991 respectively. The answer to this might be: yes, but governance changes brought about in 1978 in China and in 1991 in India fell on fertile ground there with great potential. But then, when the size of the home market is brought in as a factor, how to explain the successes of, say, tiny Singapore, Ireland, Luxembourg, Estonia and other small, fast growers? The charm of the good governance indicators was that they seemed to be able to explain it all, but the economic profession is a tricky business.

Dani Rodrik and others conclude in a paper that thoroughly examines the factors that determine growth, including geography and the governance indicators: "the distinction between institutions and policy is murky, as these examples illustrate" and "How much guidance do our results provide to policymakers who want to improve the performance of their economies? Not much at all. Sure, it is helpful to know that geography is not destiny, or that focusing on increasing the economy's links with world markets is unlikely to yield convergence. *But the operational guidance that our central result on the primacy of institutional quality yields is extremely meagre* (emphasis mine)."[28] It is also confusing, if not ironic, that whereas property rights and the rule of law are considered as crucial in the context of "institutions", in today's fast growing China the first one of these two is not always assured and the quality of the second is dubious. Also Keefer in his contribution on governance in *Dancing with Giants* has to sort of

[28] Dani Rodrik, Arvind Subramanian, Francesco Trebbi: "Institutions Rule: The Primacy of Institutions over Geography and Integration in Economic Development", NBER Working Paper, 2002.

reason away China's actual institutional situation, including democracy (voice and accountability), and explain its growth success (see also the scatter diagrams at the end of this book, which give a "mixed message").

One factor is almost surprisingly absent in most of the more recent analysis, that is direct government intervention in the economy, *the visible hand of government* or active "industrial policy". The term and the subject appear to be no longer fashionable in today's economic analysis. However, it cannot be denied that government played an active role in the growth stories of, for instance, Japan, Korea, Singapore and Taiwan, and earlier on in European countries. With some flexibility China's special zones and the US's high import tariffs in the early stage of the latter's industrialisation process may still be considered as being part of "government regulation". But the role of state-owned industries, including banks, in China today, or in France and Germany early in their industrialisation process, probably deserves greater attention and more thorough analysis than it is the case in most development or growth analysis today (unless one would smuggle them into "institutions", but that is not how I interpret the "institutions are all" scholars).

So have we learned something or is the sobering answer: *growth happens and nobody knows exactly why?* To some extent it is the latter, although many plausible conjectures can be made and factors helping growth indicated. The search for the "key to growth" leads to "indicators", but also to the conclusion that there is not a one-serves-all recipe. Let us also keep in mind that the good governance indicators are all based on subjective assessments made by a multitude of people and organisations. They are as good as they are, i.e., the best thing available, not more than just that.

Another point to keep in mind is that it is easier to explain growth once it is happening and to explain wealth once it has been achieved then to actually forecast or trigger growth. Nevertheless, in particular the more recent growth stories of the "Asian tigers" do seem to give clear hints how growth can be "created", including through active government interference. Lessons can be learned from these stories, but each country and each situation has it specificities. The economic discipline is not a "hard" science and economic growth cannot be produced in the way a building is constructed or a bridge. To conclude it may be useful to add that the meaning and the measurement of practically any social data, GDP to begin with, let alone "the rule of law", always contain a degree of uncertainty and inaccuracy, which further complicate the exercise. However, we do have hints, indicators, hypotheses and pointers.