FEBRUARY 2015

Enhancing growth prospects in China

Justin Yifu Lin

Ensuring China meets its full potential will help sustain rising global prosperity, according to Justin Yifu Lin, professor and honorary dean of Peking University's National School of Development.

In the 35 years since China's transition to a market economy began, the country has grown at an average rate of 9.8 percent per year—an explosive and unprecedented rise. While it is unlikely to experience that level of growth going forward, taking steps to ensure that China meets its full potential presents an enormous opportunity.

China's economic growth has been slowing over the past five years. In the third quarter of 2014, it was just 7.3 percent, and the country is likely to continue to face stiff headwinds, at least when compared with previous decades. As policy makers in 2015 draw up the country's 13th Five-Year Plan (2016–20), they will grapple with two fundamental questions: how fast can China expect to grow, and what should they do to support that growth?

As Adam Smith discussed in *An Inquiry into the Nature and Causes of the Wealth of Nations*, economic growth depends on improvements in labor productivity, which today result from either technological innovation or industrial upgrading. Here, China should be able to benefit from the "latecomer advantage." Unlike developed countries that are already fully exploiting advanced technology, China can achieve technological advances through imitation, importation, integration, and licensing—a lower-cost and lower-risk avenue to productivity improvement.

That helps to explain how developing countries have sometimes been able to sustain annual growth rates of 7 percent or higher for periods of 20 years or longer. The trajectories of such countries as Japan, South Korea, and Singapore would suggest a potential growth rate for China of roughly 8 percent for at least the next decade. Weak conditions elsewhere in the world, however, are likely to diminish exports and thus lower that rate to between 7 to 7.5 percent.

But potential growth is just one part of the story. Actually achieving it depends on domestic conditions and the international environment. To exploit the latecomer advantage, China must deepen its reforms and eliminate its economy's residual distortions—for instance, liberalizing the financial market; removing the Hukou (household registration) system, which restricts labor mobility; and enhancing the social safety net, to name just a few things. Meanwhile, the government should play a proactive role in overcoming the market failures, such as externalities, that are certain to accompany technological innovation and industrial upgrading.

China has a second advantage. It has the potential to fuel robust growth with domestic demand—and not only household consumption. The country suffers no lack of investment opportunities, with significant scope for industrial upgrading and plenty of potential for improvement in urban infrastructure, public housing, and environmental management. Moreover, with low government debt and private savings that amount to 50 percent of GDP as well as $4 trillion of foreign reserves, it has the resources to fund those investments. Even under comparatively unfavorable external conditions, China can rely on investment to create jobs in the short term; and as the number of jobs grows, so will consumption.

As policy makers plan for the next five years, they should set China's growth targets at 7 to 7.5 percent, adjusting them within that range as changes in the international climate dictate. Such a growth target can help to stabilize employment, lower financial risks, and achieve the country's goal of doubling incomes by 2020.

Justin Yifu Lin is professor and honorary dean of the National School of Development, Peking University, and former chief economist and senior vice president of the World Bank.