It should come as no surprise to anyone who has thought seriously about the subject, that economic growth in China that moves the country into the ranks of middle income countries will have a profound effect on the world at large. China, after all, has one-fifth of the world’s population, or roughly twice the population of the European Union, the United States, and Japan plus a handful of other high income nations.

China today, of course, is not a middle income nation. At the official exchange rate China in 2004 China had a per capita GDP of US$1,300 and total GDP of US$1,690 billion. The purchasing power parity GDP per capita, to be sure was much higher, perhaps US$4,000 or more, but when looking at the impact on the world economy, it is the exchange rate GDP calculation that is most relevant. If total GDP grows at 7 percent per year over the next ten and twenty years, Chinese GDP will double by 2015 and increase four fold by 2025. Actually the dollar value of GDP will no doubt increase by substantially more than that particularly if China continues to push export growth and possibly even if it does not. The reason is that China’s currency over this period, like the currencies of Japan and the other rapidly growing economies of East Asia in the past, will steadily appreciate in real terms. Thus in a decade Chinese GDP could reach say US$4,000 billion and in two decades possibly US$ 10,000 billion or more.

If this happens, the impact on the world demand for resources will be large even if China takes major steps to conserve energy and the same can be said about the impact on the emission of green house gasses. If this growth is fueled by export expansion, even if at half or less the current percentage increase in Chinese exports and imports, China will be by far the largest trading nation in the world. Defense expenditures in China could also rise to levels not much different from those of the United States today.

But whether or not these changes will actually occur depends first and foremost on whether growth will in fact continue at an average rate of 7 percent or more over the coming decades. Any realistic forecast of China’s growth must analyze the prospects for China at three different levels.

(1) The level of what I call growth fundamentals. The question here is whether the key inputs into growth—investment in physical capital, investment in human capital, and the growth rate of the labor force will continue to grow as rapidly as in the past. More importantly, the issue is whether the productivity of these inputs (total factor productivity) will continue to remain high. As for the growth of capital and labor inputs, there is little question that China, barring a political catastrophe, can continue to maintain a high rate of investment, a continued rapid expansion of education at the secondary and university level, and continued rapid growth of the modern sector labor force (mainly because there remains a huge pool of underused labor in the countryside and that pool will not be depleted within the next two decades).
(2) But the question of whether productivity will remain high is more difficult to answer. China has gotten spurts in productivity first from the rural reforms of the first years of reform, then from the township and village enterprises, and in the 1990s from foreign direct investment, but after a period these sources of productivity growth have begun to run out of steam. The question for the future is whether China will find a new source of productivity growth? My own view is that the most likely source will involve moving from China’s current market economy with a high level of government intervention to a market economy with much less intervention. This will involve a complete reform of the financial system, the development of a more effective legal system, and protection of minority shareholder rights. If these changes occur, China will also experience a gradual reduction in corruption from its current high levels. Put differently, China probably will have to move a long way from an economic system dominated by the kinds of industrial policies pioneered by Japan and pursued effectively for a time by South Korea. There is simply too much politics and corruption in Chinese industrial decision making for the country to continue to achieve high productivity growth with the kind of market system it has today.

(3) There are other problems that will have to be dealt with as well. China is facing a growing equity problem as the rural areas continue to grow very slowly while the urban areas and their surrounding suburbs boom. The result is the largest migration of people from the rural to urban areas in the history of the world and that migration is going to accelerate over the next two decades. The tensions created by relative stagnation in the rural areas, the continued use of the hukou or registration system to limit the rights of migrants, and the laying off of many older workers by failing state owned enterprises have become increasingly explosive. The thousands of demonstrations that sometimes turn violent are not yet a threat to the government, but whether that will continue to be the case remains to be seen. These tensions are rising at a time when a reasonably well educated and urban middle class is growing rapidly and it also remains to be seen how much longer that group will be willing to forego greater participation in political decision making.

All of these caveats not withstanding, it is my view that China is likely to continue to grow rapidly for the next decade and probably for some time thereafter. This assumes that there will be no war in the Taiwan straits and that political tensions will continue to be managed reasonably effectively from the point of view of maintaining a stable environment for investment.

Given the likelihood of continued growth, what then is the impact on the world economic system:

(a) Since China has limited natural resources, the incremental increase in demand for these resources will have to come mainly from imports. Demand for energy and for certain other resources will thus grow very rapidly and China will have to expend large amounts of foreign exchange on their purchase, but China will have the foreign exchange required. What will be the impact on the world prices of these natural resources? Answering that question requires knowledge of the likely supply response of those with surplus natural resources, a subject that is beyond the competence of this writer. It is safe to assume that prices for these
commodities will be higher than if China were not growing rapidly, but probably not by as much as some of the more frightening forecasts being made.

(b) Will China be able to continue to expand exports at anything like the rates of the past decade? That seems unlikely. With exports this year probably passing US$700 billion, it is hard to see how Chinese exports can keep on doubling every five or six years and thus it seems likely that the growth of Chinese exports will slow as the currency revalues and potential markets are increasingly blocked by protectionist defenses. China will thus have to sustain the demand side of high growth through the more rapid expansion of domestic demand and that will be a challenge.

(c) Finally China’s economic growth will also have a profound impact on the world if, as seems likely, China continues to expand its military expenditures at anything like the pace of the past decade. Simply expanding military expenditures will not necessarily turn China into a military power with global reach since that kind of power involves advances in technology as much or more than simply spending more money to buy existing technology. But it seems reasonably clear where China is heading in this regard and over time one suspects that Chinese military technology will gradually catch up as the technological level of the economy as a whole catches up. Thus China will become a formidable military power over the next two decades. How it will use that power, if at all, is far beyond the scope of this essay and the competence of its author.

The bottom line of this discussion is that China’s growth is likely to continue for some time and, if it does, it is going to have a profound impact on the world as we know it today.