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The Coming Chinese Slowdown: Resolving the Paradox of Freedom and Growth

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Wall Street's sell-off on February 27 was triggered by a severe drop in China's equity markets. On that day, all of the major U.S. indices experienced declines of between 3 and 4 percent, including the Dow Jones Industrial Average, the S&P 500, and Nasdaq. Though the U.S. bond market rose, Treasury bonds have long been buoyed by massive investments from China's government. The 9 percentage point plummet of Chinese equities in one day, the worst performance in a decade, sends a sharp reminder and a warning. The reminder is that the economies of China and America are deeply integrated—the Sino-American engine is at the heart of globalization, after all. The warning is that the Sino side of the engine is strong but not stable.

One view of China doubts its economic strength and suspects that its macro statistics may be padded. Another view is that the data is real but that China offers an alternative form of economic development to the Washington Consensus—that is, the Anglo Model of corporate capitalism. Neither view holds. The data on imports from China are real enough: Measured in dollars, the United States imported $288 billion worth of goods in 2006, compared to less than $4 billion in 1985. As for those who wish to believe China has discovered a new development model, Adam Smith would argue there may be many paths up the mountain but they lead to the same place: free markets.

Indeed, during our tour of Asian, European, and American capitals promoting the *2007 Index of Economic Freedom*, one question constantly arises: If economic freedom matters so much for growth, how is China doing so well? With a famously rapid rate of GDP growth, exceeding 10 percent annually for what seems like two decades, and a sub-par score of 54 percent in economic freedom, China's modern economy appears to be a powerful rebuke to the central claim that freedom and prosperity are linked, as is written on the cover of the book. The "China counterpoint" has led many to dismiss the role of freedom in economic development.

The simple answer is that searching for a direct link between the level of freedom and growth in income is futile. This is not a confession, but a suggestion that those who care about human progress drop the dogma and think about the economics. Growing economies are not accidentally free. They have to become free first, and it is the growth in one that leads to the growth in the other, not the mere level.

Obviously, poor countries have the most potential to grow, a potential that is usually unmet. Rich countries, in contrast, have far less potential to grow and can do so only by inventing new technologies and institutional arrangements. And it is no secret that rich countries tend to enjoy more freedoms of

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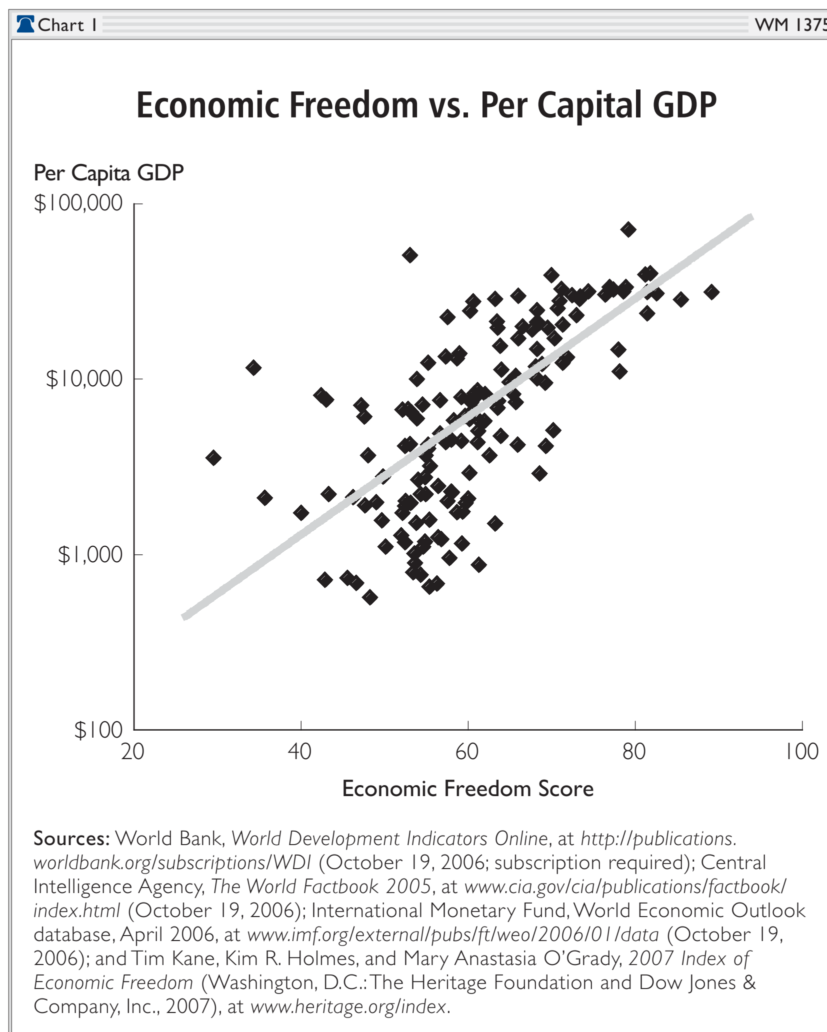
all kinds: political, economic, religious, and so on. High levels of freedom correlate with high levels (not growth rates) of GDP per capita. And so it is that 12 of the 20 freest economies in the *Index* are European, while the top five economies have deep European roots—they are all ex-British colonies, including the U.S. in fourth place.



Sources: World Bank, *World Development Indicators Online*, at *http://publications.worldbank.org/subscriptions/WDI* (October 19, 2006; subscription required); Central Intelligence Agency, *The World Factbook 2005*, at *www.cia.gov/cia/publications/factbook/index.html* (October 19, 2006); International Monetary Fund, World Economic Outlook database, April 2006, at *www.imf.org/external/pubs/ft/weo/2006/01/data* (October 19, 2006); and Tim Kane, Kim R. Holmes, and Mary Anastasia O'Grady, *2007 Index of Economic Freedom* (Washington, D.C.: The Heritage Foundation and Dow Jones & Company, Inc., 2007), at *www.heritage.org/index*.

To put it differently, a newborn baby will have a faster rate of weight gain than the child's mother. Even if the adult has perfect nutrition, and the newborn were subsisting on a poor diet, the adult might not change in weight at all, while the child would double his in a year. Countries are like this. Some have mature systems, and others varying levels of maturity. The most immature economies that enhance their nutrition will enhance their growth rates faster too, and comparisons to mature economies must be made very carefully.

Jeff Sachs famously used the China counterpoint in his book, *The End of Poverty*, which contains an amateurish chart showing the level of freedom on one axis and the change in GDP per capita on the other. Ironically, the China counterpoint is most popular in Europe, where there is great unease about weak growth and no small amount of denial over the causes. The people who find the counterpoint unpersuasive are, naturally, the Chinese.

Economic Freedom and Growth in China. To be sure, China's economic freedom measures just 54 percent in 2007. But 30 years ago in 1977, the measure would have been near zero. By quietly setting aside Maoist dogma in 1978, the introduction of property rights for small farmers by Deng Xiaopeng initiated a revolution in economic freedom. As Milton Friedman anticipated, this small infusion had dramatic and positive effects. Within a few years, the Communist Party was promoting the slogan "It is glorious to be rich." Looking back, China's economic freedom has grown by 1 or 2 percentage points every year for 30 years, and the economy grew along with it: a growth-growth relationship.

Clearly, the freedom-to-prosperity relationship is strong. What the Chinese government has done is raised China's growth potential by enhancing economic freedom. Nobel Laureate Ed Prescott and co-author Stephen Parente call this a reduction in the "Barriers to Riches," also the title of their book. The framework Parente and Prescott use is consistent with our approach: Economic prosperity is natural, but governments institute controls on the economy that constrain it.

Chart 1 reveals the statistical relationship between freedom and GDP per capita using 2007 data on 157 countries as observations. The relationship is

clear because the chart uses GDP levels, not growth rates. Note that GDP per capita is measured using an exponential scale. The rough interpretation of this chart is that a 10 percentage point increase in economic freedom leads to a doubling of income. This means that even small improvements in freedom can have dramatic welfare impacts. The lesson is that more freedom leads to more growth, but stagnant freedom (even if high) leads to stagnant growth rates.

Average incomes in China are relatively low compared to the West, a point relentlessly made by those in the U.S. who decry outsourcing. But China was much, much poorer two decades ago. Young workers in China today are making four to five times more than the previous generation. And it is not cheap labor fueling China's rise. The tautology of the "cheap labor" and "labor arbitrage" theories does not explain why Africa is not booming—wages there are much cheaper than in China. No, it is freedom in China that has made all the difference, at least until the reforms stopped coming a few years ago.

A Turbulent Rise? So will China's double-digit growth boom last? There are many signs that an abrupt slowdown is coming. A discouraging signal was sent in a February speech by Luo Gan, a Chinese official and politburo member, who announced Beijing would resist "enemy forces" that are trying to Westernize the legal system.

Consider the numbers. Rich countries have freedom scores around 80 percent, so a score of 50 percent implies three halvings of relative prosperity, or one-eighth the per capita income. China actually has about that level of income, but is still growing strong. China's 54 percent score compares to an 82 percent score for the U.S.A. That may well signal that China is approaching a ceiling on its growth curve. Like Japan decades ago, China's growth rate is likely to decelerate by a few percentage points every few years until it approaches a cruising speed in line with the growth rate of other industrial economies.

The other scenario is an outright crash. Our analysis of China's economy is comprised of 10 specific economic freedoms. On four, Chinese economic freedom equals or exceeds many other economies globally: limited government expenditures, low tariffs, stable money, and moderate labor freedoms. But China is far behind in three freedoms. Property rights are rated as 20 percent free, whereas financial freedom and investment freedom are both 30 percent.

The Chinese ship of state has brilliant sails but a paper hull, and its weaknesses will be invisible until crosswinds blow. In short, the fragile financial system is unlikely to sail through even a mild national cyclical recession. Such an event could easily cascade into a severe recession. Indeed, the consensus on the Great Depression of the 1930s is a story of a mild downturn in the U.S. that produced a crisis when the banking system cracked under a mass panic (and bad monetary policy by the Federal Reserve).

The principles of central bank policy are much better understood today, but even if the Chinese government pushes liquidity in the face of a downturn, there is no telling how China's opaque financial structure will hold up. The implications of a Chinese depression are much darker than contemporary American concerns regarding China's trade imbalance. Financial markets are the foundation for goods markets, and a meltdown of both in China will hit America's economy hard.

In the end, it isn't American diplomacy, Wall Street pressure, or any other "enemy forces" that will make Beijing budge. The aspirations of 1.3 billion Chinese will demand security as well as growth. And the Chinese are much more appreciative of the lesson that real economic security derives from individual freedom, not from the state.

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