The China Debate

How to avoid a further crash in economic growth.

By Chi Lo

Will China escape the middle-income trap, or will it see its economic growth rate crash? This debate underlies the concern about how China will disrupt the global system as it approaches global power status. There are strategic policy and investment implications that one can draw from China's growth trajectory.

China could avoid falling into the middle-income trap if it breaks the constraints of population, capital, and productivity on economic growth. Consumption-led growth and industrial upgrading will be two of the key emerging themes in China's structural change story over the next thirty years, during which President Xi Jinping's "Chinese Dream" is supposed to yield some tangible results. The structural switch from quantity growth to quality growth has just begun. The ultimate question is who will benefit from China's transition from being the world's factory to a high-income, high-tech, and consumption-led economy.

China's annual GDP growth has fallen from double-digit rates between 1980 and 2012 to around 7 percent since President Xi Jinping took office in 2013. Growth is now expected to fall below 6 percent in coming years. This declining trend seems to vindicate warnings of the dreaded middle-income trap: the tendency of fast-growing developing economies

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to revert to a much weaker growth trajectory and stagnate when per capita income approaches the upper bound of the middle-income range between US$6,000 and US$12,000 a year. China's per capita income in 2018 was already US$10,200.

Economic growth is a function of the two factors of production—labor/population and capital—and a residual factor—productivity. As a country grows towards its production possibility frontier which defines the size of the economy, diminishing marginal returns set in. If there is no growth in productivity, overall economic growth will stagnant and eventually decline.

GROWTH CONSTRAINTS RELAXED?

Whether China can break out of the middle-income trap and move to a high-income economy depends on its labor, capital, and productivity constraints. Relaxing these constraints can increase the size of the economy. First, regarding labor, what is less well known about China's aging population problem is that it may not bite for another twenty years. Labor may not, in fact, be a growth constraint as commonly believed.

There are natural demographic dynamics for expanding China's labor force to counteract its contraction under the prevailing static framework. My research shows that China can easily find more than 200 million workers in the next twenty years through urbanization and changes to retirement and regional migration policies to offset the expected loss of 200 million workers between 2030 and 2045. To wit, in 2018 China had 250 million young people aged 0–15 years old who will be in the labor force in sixteen years. If we assume the urban/rural distribution of this age cohort follows the national distribution, where 41 percent of the population is rural, in the next sixteen years these 100 million-plus people can be urbanized. Further urbanization of the adult rural population (15–64 years old), estimated at 402 million in 2018, will augment the labor force in the coming years. Assuming half of this population was 15–30 years old in 2018, there will be more than 200 million members of the rural working-age population who can be urbanized in the next twenty-plus years.

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Furthermore, if China could boost its 68.4 percent labor participation rate to Japan's 79 percent, for example, its labor force would increase by 26 percent (or 162 million). Successful industrial restructuring will lead to higher labor participation by increasing the incentive to work longer to take advantage of new opportunities offered by the private sector. Any change in the population policy that can boost the birth and urbanization rates will add to these forces. Crucially, industrial migration towards the inland will also add to growth by tapping cheaper resources and spreading income growth more evenly across the country.

The structural switch from quantity growth to quality growth has just begun.

Contrary to conventional wisdom, capital also does not seem to be a growth constraint for China in the medium to longer term, despite the existence of excess capacity. China only started building up capital in the late 1980s while most of the other major economies started in the 1950s. Even after forty years of catching up, its capital stock per worker is still significantly less than the major economies and its Asian peers. China's capital stock per worker is only 23 percent that of Singapore, 32 percent that of the United Kingdom, 30 percent that of Germany, 34 percent that of the United States, 40 percent that of Japan, and 39 percent that of South Korea.

Seldom discussed is a conundrum that China suffers from under-investment as well as excess capacity. The coexistence of these two conflicting forces lays bare a serious structural flaw of capital misallocation. The conundrum argues that China's economic inefficiency was not due to too much investment but to the state sector's soft budget constraint that misallocated capital to a few giant inefficient state industries. This has created excess capacity that has dominated the economy and stymied private-sector "animal spirits," resulting in under-capitalization in other parts of the system.

Meanwhile, China's total factor productivity growth seems to be recovering from the decline in recent years under President Xi's "new normal" policy, which aims at keeping GDP growth at a moderate 6–7 percent range and implementing structural reforms and paring debt. Previous debt-fueled excess investment led to sluggish or

Continued on page 62

Continued from page 49

even declining productivity growth. The new normal policy has also shown some initial success in reversing the diminishing marginal returns on investment in the Chinese economy, implying an improvement in the GDP growth quality.

The aim of the "Chinese Dream" is to move the economy into high-value–added high-tech production through manufacturing and industrial upgrading. Already, the growth of high-tech industries has outperformed overall economic growth significantly. China's aim to become a technology powerhouse by 2050 should help raise productivity growth.

ESCAPING THE MIDDLE-INCOME TRAP

If labor will not be a growth constraint for another twenty years, capital continues to accumulate, and productivity growth revives under the new technology-focused development policy, the size of China's economy can be expanded. Even if China's per capita GDP grows by an average of only 5 percent a year for the next decade, its per capital income will breach the US$12,000 middle-income threshold by 2028 and make it a high-income country.

Empirical evidence shows that the propensity to consume of a typical economy continues to rise from the US$6,000 to US$12,000 per capita income levels, with the consumption pattern moving into higher value-added goods and services, such as mobile phones, cars, tourism, and personal services. Above the US$12,000 level, consumer demand will move into even higher value-added goods and services, including education, healthcare, financial services, and assets.

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The Chinese economy is far from being mature.

Hence, upgrading of consumption and industries will be two of the key emerging themes for China's structural change story in the post–middle-income world. The next question is which industries/sectors will benefit from this new China economy, as many global players would like to analyze the strategic policy and investment implications.

THE FUTURE WINNERS

Chinese consumers have been upgrading their demand for goods and services alongside income growth since the turn of the millennium. For example, consumer spending on healthcare rose by 5 percentage points to 11 percent of total between 2000 and 2014, but consumer spending on crops dropped by 9 percentage points to only 5 percent in the same period.

As China moves into rich-country status, its consumption patterns should also converge with those of a developed country. Especially in areas such as health care, real estate, and retail trade, China's consumption lags that of developed countries. Basically, the larger the gap, the bigger the room for that industry in China to benefit from consumption upgrading.

Meanwhile, those industries that have greater room to climb the value chain through technological innovation will benefit more from industrial upgrading. In the areas of healthcare and consumer electronics products in particular, productivity in China lags that of developed economies. The bigger the productivity difference, the bigger the room for that Chinese industry to gain from industrial upgrading.

THE REAL CHINA GROWTH STORY

The Chinese economy is far from being mature, despite how most players see it. Structural reforms are crucial for pushing China's long-term growth potential beyond the current production capacity. Certainly, the days of 10 percent or more Chinese growth are over. This is inevitable. But there are good reasons to argue that China's real growth story of shifting output from quantity to quality has just begun. ◆