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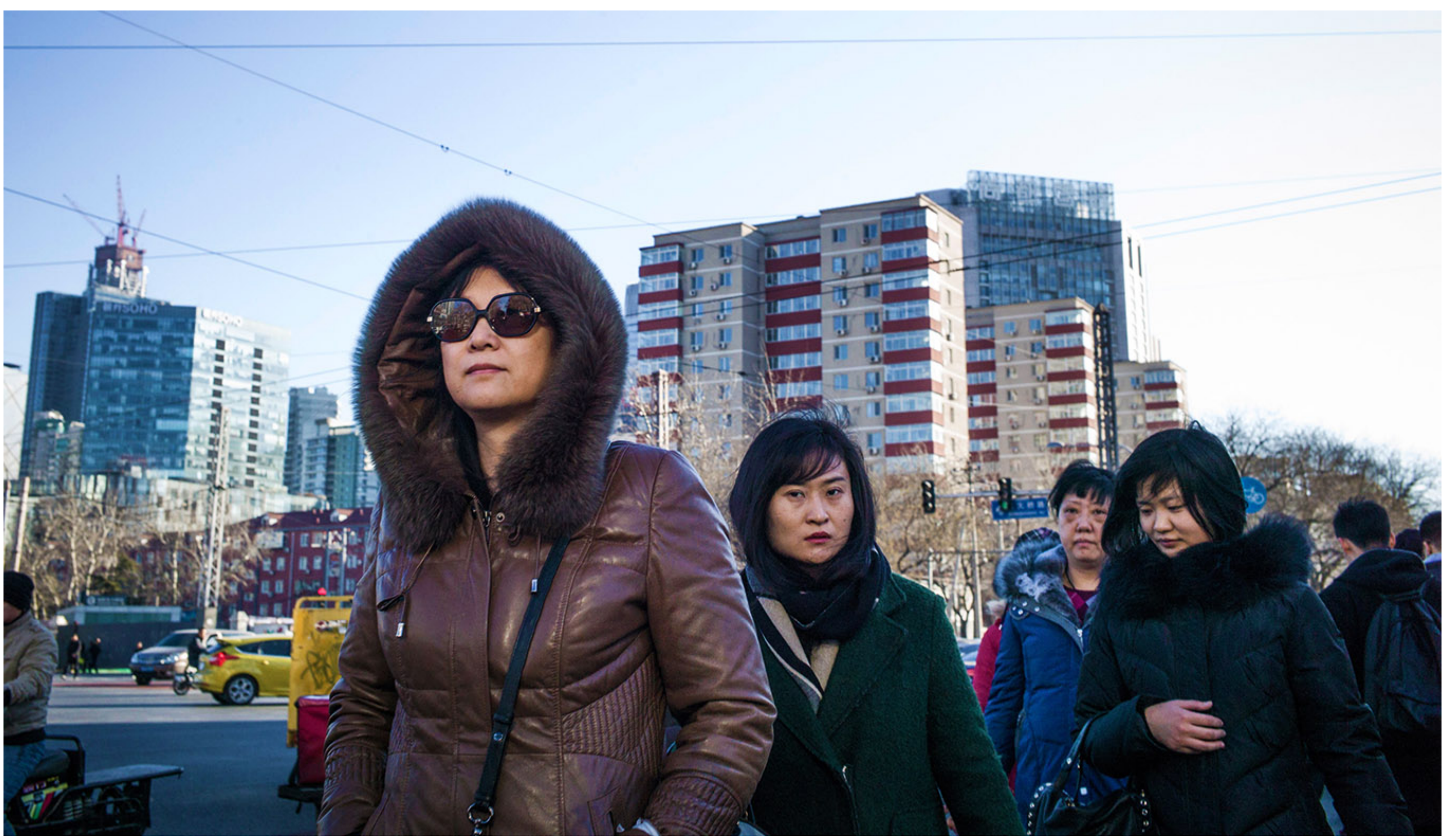
Issue Adviser: a critical review of *Project Syndicate's* hardest-hitting commentaries on an urgent global issue.

**University of California, Davis, economist [Wing Thye Woo] engages the views of Keyu Jin, Justin Lin, Stephen Roach, and other *Project Syndicate* commentators, to ask whether China can avoid the "middle-income trap," even as it reckons with Donald Trump's presidency.**

China's Growth Odyssey



China's steadily declining rate of economic growth is a problem for both China and the world economy. Now that US President Donald Trump is set to wreak havoc on global stability, can China still hope to achieve the widely shared prosperity it has long sought?

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SHANGHAI – Will China's sociopolitical stability and economic dynamism continue to hold? It's a question China-watchers are asking more frequently now than at any time in the past three decades. This fall, the 19th Congress of the Communist Party of China will decide (or not) President Xi Jinping's successor in 2022, while also replacing (maybe) five members of the seven-member Politburo Standing Committee. The result, one hopes, will not be a new period of turbulence like that which the election of Donald Trump has unleashed on the United States.

The potential for political uncertainty in China comes at a time when its economy's health seems to be waning, and when Trump's presidency could pose a direct challenge to its growth model. From 1979 to 2010, China's GDP increased at an average annual rate of 10%, generally exceeding the government's target (the exception being the 1989-1990 period, following the mass incident at Tiananmen Square). But then growth slowed to 7.9% in 2012 and 7.8% in 2013, leading the government to declare a "new normal." When growth slowed further, to 7.3%, in 2014, and remained sluggish the following year, the government announced that the target growth rate for the next Five-Year Plan (2016-2020) would be 6.5-7%. Sure enough, the growth rate has continued to slide, to 6.9% in 2015 and 6.7% last year.

The steady deceleration of economic growth since 2010 has become an albatross around Chinese policymakers' necks. Properly diagnosing the cause, and formulating the right policy response, will not be easy. But whether China succeeds will have far-reaching implications for the world economy, especially now that Trump is confirming worst-case scenarios regarding his administration's impact on global stability and prosperity.

Perspectives on China's economic trajectory run the gamut, from deep pessimism to buoyant optimism. *Project Syndicate* commentators reflect this range of views as well. Nonetheless, having taken a hard look at China's politics, policies, and economic trends, all furnish valuable insights into what might – and what should – come next.

Keep Calm and Carry On

Former World Bank Chief Economist Justin Yifu Lin is sanguine about the Chinese economy's capacity to deliver sustained growth. "China has been suffering from the aftereffects of the 2008 financial crisis and plummeting export demand," he writes. Consequently, the recent slowdown owes more to "external and cyclical factors, not some natural limit." Lin is confident that policies to boost domestic demand – including "improvements in infrastructure, urbanization efforts, environmental management, and high-tech industries" – will prove sufficient to meet the government's official growth targets.

As Lin argued in an earlier commentary, China still has significant room to grow, because its *per capita* income in 2008 was still "just over one-fifth that of the United States." When Japan's *per capita* income was that far behind the US, in 1951, it then "grew at an average annual rate of 9.2% for the next 20 years." Lin attributes this growth to developing countries' "latecomer advantage," whereby they can improve productivity simply by adopting developed countries' technologies and best practices, at little cost and with few risks.

Similarly, Jim O'Neill, a former chief economist at Goldman Sachs, is "less worried than others about frequently cited risks confronting the Chinese economy," owing to the fact that "Chinese consumer spending has remained strong despite the slowdown in industrial output and investment." And Yale University's Stephen Roach echoes this view, arguing that "China has the strategy, wherewithal, and commitment to achieve a dramatic structural transformation into a services-based consumer society."

Roach is confident that China can dodge the "daunting cyclical headwinds" confronting it, and Nobel laureate economist Michael Spence and Fred Hu of Primavera Capital Group seem to agree. While they acknowledge that "the Chinese trade engine has lost much of its steam," they attribute this to "weak foreign demand," and conclude that "China's transition to a more innovative, consumer-driven economy is well underway." In Spence and Hu's view, China's economy "is experiencing a bumpy deceleration, not a meltdown": the growth rate has temporarily strayed from the long-term norm. Focusing on softening the bump, rather than raising the norm, they advise the Chinese government to "increase the transparency of its decision-making, including by communicating its policy decisions more effectively."

Obstacles Abroad and at Home

With Trump now in the White House, however, China must account for changes in its economic environment that it cannot fully control. As Claremont McKenna College's Minxin Pei bluntly puts it, "De-globalization now seems to be a given." And this is "profoundly worrying for China, the world's largest exporter by volume and arguably globalization's greatest beneficiary." Cornell University's Kaushik Basu makes a similar point, and predicts that "Trump is about to make a policy mistake." His "neo-protectionist" brand of tariffs, combined with financial deregulation, will not hurt only the US, Basu argues, but also any country that runs "large trade surpluses *vis-à-vis* the United States" – namely, China.

But China must confront serious domestic challenges as well. Keyu Jin, a professor at the London School of Economics, disputes the notion that China's growth slowdown is a temporary symptom of its changing economic model. "China's problem is not that it is 'in transition,' " Jin says. "It is that the state sector is choking the private sector." China's state-owned enterprises (SOEs), she points out, receive preferential treatment in the form of implicit government guarantees and cheap land and credit, which creates unfair competition for the private sector. "If China is to avoid economic decline," she concludes, it will need to pursue root-and-branch societal reforms, not least to "its governance system – and the philosophy that underpins it."

Zhang Jun, the Director of Fudan University's China Center for Economic Studies, also believes that the state sector poses a major threat to China's economy, and calls for "a far-reaching restructuring of large SOEs." He outlines the positive knock-on effects of shutting down state-backed "zombie" firms and limiting SOEs' role to just a few relevant economic sectors – a process former Premier Zhu Rongji started but did not finish two decades ago. "This approach," Zhang argues, would finally allow private firms to enter into the "SOE-dominated, capital-intensive, and high-end service industries"; at the same time, it would "create an opportunity to advance privatization, which could bolster innovation and competitiveness."

But Zhang harbors no illusions that serious reforms will be forthcoming, or even successful, as China continues to reorient its economy toward domestic consumption. "Notwithstanding the significant economic potential of Chinese consumers," he notes in an earlier commentary, "economic development based on diversified domestic demand is more complicated than export-driven development." He warns that "the new businesses emerging from the shift to a new growth model are demanding far more from China's current economic-governance system than it can bear." To be sure, structural reforms could address this problem, but they will also require "China's leaders to make tough political decisions that won't please everyone."

Indeed, any discussion of China's economy must address the political choices it faces. For the New School's Nina Khrushcheva, Chinese President Xi Jinping has initiated an era in which "collective leadership has given way to one-man rule, and the unwritten rules of behavior have been junked." Taken together, Xi's re-centralization of power, prosecution of potential rivals, crackdown on the domestic media, and efforts to reinforce the "Great Firewall" to block foreign websites amount to a major setback for

China's sociopolitical progress – and possibly for its economic progress, too.

But Jin disagrees with this interpretation, and insists that "Xi Jinping is no Mao Zedong." For Xi to "strengthen China – both its government and its economy," she writes, "he must bring a bureaucracy that has spun somewhat out of control back into line." According to Jin, this is necessary in order to reverse "over three decades of lax governance," during which "local authorities have formed political cliques that work together to protect their illicit gains and economic interests."

Muddying the Waters

These differing outlooks reveal the difficulty of diagnosing China's post-2010 economic slowdown. It is safe to say that the tepid performance of recent years reflects both cyclical dynamics and a decline in the economy's overall growth potential, but the significance of each factor remains to be determined. As Yu Yongding, a former member of the Monetary Policy Committee of the People's Bank of China, points out, neither can be considered in a vacuum: long-term supply-side and short-term demand-side weaknesses must be addressed simultaneously. Thus, the solution is not as simple as choosing "between Keynesian stimulus or supply-side reform," Yu argues; rather, the authorities face "a challenge in balancing the two."

Yu's analysis suggests that Chinese policymakers are focusing too narrowly on long-term variables, and not enough on more immediate growth hurdles. Since November 2015, the official narrative has overwhelmingly emphasized "supply-side structural reform," implying that Xi views the recent slowdown as being the result primarily of a decline in the potential growth rate. By contrast, Yu calls for "another stimulus package that increases aggregate demand through infrastructure investment" in the near term. This should be financed "mainly with government bonds, instead of bank credit," so as to "avoid the kinds of asset bubbles that swelled in the last several years." Of course, while Yu's proposed stimulus may prevent a financial crisis, the additional debt could contribute to a fiscal crisis instead.

But the point of infrastructure investment, Yu maintains, is "not just to prevent the economy from sliding further, but also to enable China to generate the sustained long-term growth that it requires to achieve developed-country status." To be sure, with *per capita* GDP at only 30% of the US level, China still seems to have plenty of room to grow. So why should anyone be pessimistic about the sustainability of high growth?

For starters, the benefits of the "latecomer advantage" that Lin emphasizes cannot be taken for granted. For example, taken together, the five largest Latin American economies' *per capita* GDP, adjusted for purchasing power parity, was around 30% of the US level in 1955, and that ratio remains the same today. While these countries' absolute standard of living has improved, the size of their development gap *vis-à-vis* the US has not changed in more than 60 years.

This failure to catch up is generally known as the "middle-income trap." And, as Ernesto Talvi of the Brookings Institution points out, it is no coincidence that the past 40 years of Latin American history has been marked by cycles of political disruption. Similarly, growth slowdowns in Malaysia and Thailand over the past two decades have led to large-scale protests and episodes of political violence.

Moreover, the middle-income trap is the norm. The only large Asian economies that have managed to narrow their development gaps relative to the US are Japan, Taiwan, and South Korea, and China's problems are too large and complex simply to assume that it shares its neighbors' economic exceptionalism.

Old and in the Way

One fundamental reason for doubt consists in China's demographic headwinds, which will make it difficult to restore past growth rates. Back in October of 2011, Cai Fang, the Director of the Institute of Population Economics at the Chinese Academy of Social Sciences, pointed out that China, unlike Japan and South Korea, became an aging country well before it became affluent. He worries that this factor alone could cause China to fall into a middle-income trap.

A rapidly aging society will increasingly have lower savings (and thus less investment), and will accumulate human capital at a slower rate. Meanwhile, the country's population will also decline, which will lead to decreased production, and fewer opportunities to reap benefits from economies of scale.

The experience of other aging countries does not bode well for China. In the second half of the 1990s, when Japan's dependency ratio – the proportion of the population that is younger than 15 and older than 60 –accelerated its upward rise, the GDP growth rate abruptly declined. And South Korea's rate of growth slowed significantly after 2010, when its dependency ratio began to increase rapidly. China's dependency ratio has been rising quite rapidly since 2010, though not as quickly as that of Japan after 1995 or South Korea in recent years.

In 2013, Cai used demographically-adjusted growth accounting to forecast an annual growth rate of 6.2% between 2016 and 2020. This prediction might have come true in 2016 had the government not propped up growth with monetary and fiscal-stimulus policies to keep zombie SOEs alive, enlarge the inventory of unoccupied housing in some regions, and boost demand for goods made by firms with excess capacity.

Cai's work thus raises an important question about how best to calculate future economic growth. Whereas Lin relies on a comparative analysis of US-Japan and US-Korea *per capita* GDP ratios to predict that China will maintain an annual growth rate of "roughly 8%" for the 2008-2028 period, Cai, focusing on the dependency ratio in Japan and South Korea, expects China's annual growth rate to decline. So, which variable is the best predictor of future growth?

Sound cross-country comparison cannot be based on textbook economic theory alone. It also requires deep knowledge of specific institutional conditions in each country that is being compared, because the extent to which a given variable affects future economic outcomes differs among countries. Without a holistic approach that accounts for such discrepancies, we cannot know if the same observed outcome in different countries was produced by the same factors.

Malaysia, for example, is ensnared in a middle-income trap because of its comprehensive system of ethnic preference – which has spawned rampant rent-seeking, capital flight, a large brain drain, and a low-quality education system – and its overly centralized administrative structure that suppresses local development initiatives. Thailand, meanwhile, has been forced into a middle-income trap because of political conflicts stemming from traditional elites' refusal to accommodate new social forces.

For China, an aging population is only one of the potential obstacles to sustained high growth rates. As Zhang points out, "Another fundamental challenge is China's slow rate of urbanization, which is still lagging, even after 25 years of export-led growth." Thriving metropolitan areas are necessary for a service economy, because they bring together mutually dependent service sectors such as "[information and communication technologies], finance, insurance, transportation, and real estate." Zhang laments that China's "enduring system of dividing urban and rural regions, together with poor urban planning, has led to fragmented and scattered metropolitan communities without diversified networks." More interconnectivity, Zhang believes, "would otherwise have helped boost productivity."

Trim the Sails

Andrew Sheng and Xiao Geng of the University of Hong Kong advise Chinese policymakers to address this fragmentation when they pursue macro-level supply-side reforms. There are "considerable differences in how markets work in different regions and sectors," Sheng and Xiao point out, and reforms will radically change the “interaction between the state and these markets.” They warn that this could “create far-reaching ambiguity, leading to tensions and confusion among officials, scholars, businesspeople, and the public.”

Sheng and Xiao trace China’s economic problems to the “rapid expansion of imperfect markets managed by an imperfect bureaucracy.” And while they do not specify which bears more blame – markets or the bureaucracy – they believe that the only way to fix such imperfections is to go beyond structural reform and pursue “institutional reform.” Specifically, they call on central and local authorities to “delineate property rights with regard to land, capital, and natural resources, and establish industrial standards and best practices.” They don’t explain how this institutional reform should be carried out, but delineating property rights generally means privatizing state-controlled assets. Likewise, establishing industrial standards and best practices generally means adopting them from abroad, and carefully adapting them to local conditions.

Clearly, taming China’s SOEs is necessary for restoring strong growth, as *Project Syndicate* commentators agree. This does not reflect a shared ideological bias, but rather the reality that SOEs constitute a growing burden on the economy. The largest SOEs should not necessarily be privatized, but private firms must be allowed to compete freely with them (with exceptions for certain sectors such as armaments), and hard-budget constraints and open trade must be maintained.

China should also explore policies to expand domestic innovation. As Erik Berglöf of the London School of Economics and Political Science notes, studies show “a positive link between innovation and social mobility, and even between innovation and income inequality.” Berglöf offers Chinese policymakers a ray of hope, pointing out that, “there is no historical necessity that dictates that countries get stuck at particular levels of income.” But for China to avoid this fate, he warns, it cannot rely wholly on technologies adopted from developed countries.

Finally, as Cai recommends, China will need to cultivate its human capital. Like Zhang, he sees an urgent need to improve the process of rural-to-urban migration, not least by relaxing the “household registration system (*hukou*), which bars access to public benefits for migrants without urban residence permits,” as well as restrictions on the expansion of the largest cities. Such labor-market reforms will significantly improve rural children’s health and education, reduce income equality, and promote social mobility.

With a balanced approach to political change, and with economic reforms that take into account short-term cyclical and long-term structural challenges (with much more emphasis on the latter), China can still achieve sociopolitical harmony and position itself to become a developed, high-income country. In an age of mounting global uncertainty, owing in no small part to the US, China stands to benefit enormously – particularly in geopolitical terms – if it can emerge as a source of sustained economic dynamism.

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