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Growth prospects

Beware the middle-income trap

China's roaring growth cannot last indefinitely

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CHINA'S LEADERS ARE usually shy of telling things as they are, but the prime minister, Wen Jiabao, put it bluntly when he described China's economy in 2007 as "unstable, unbalanced, unco-ordinated and unsustainable". Some foreigners may extol China's handling of the global financial crisis, but Mr Wen has stuck to his guns. The phrase even crops up in China's recently adopted five-year economic plan, standing out as an indirect admission of the failings of his own administration and as a marker for the next.



But will they consume enough?

For all its problems, China in the coming 10-15 years is still likely to reach several symbolic milestones. The IMF predicts that in 2016 it will become the world's largest economy on a purchasing-power-parity basis. The Economist Intelligence Unit, a sister organisation of this newspaper, reckons that on the basis of market exchange rates China will attain that glory in 2020. By the end of this decade, according to Daiwa Securities, GDP per person in Shanghai, China's richest city, could be almost the same as the average for America in 2009.

And for all the bubbliness of China's property market and the reckless spending of local governments, the country will probably avoid a crippling debt crisis. China has foreign-exchange reserves of more than \$3 trillion and ran a modest budget deficit of 2.5% of GDP last year. Its worries are longer-term. The economy will certainly begin to slow in the next few years after three decades of nearly 10% average annual growth. Exports will be constrained by depressed Western markets, and investments in fixed assets will produce diminishing returns. But the slowdown will be less pronounced if the government succeeds in boosting consumption as a new growth engine.

Arthur Kroeber of GK Dragonomics, a consultancy, says the country still enjoys a considerable tailwind from urbanisation and a huge potential for productivity gains as it adopts new technology. He says a scattering of white-elephant projects (including the odd ghost-town of uninhabited new housing and office developments) does not concern him: "There's no question

that there are excesses, but the basic thing they are doing is sensible.” Louis Kuijs of the World Bank agrees. He sees the trend growth rate easing over the coming decade, but not dramatically. New infrastructure is generally being put to good use. Even though investment as a proportion of GDP is high, China’s accumulated investment in fixed assets is still low. Real wages have been rising strongly, which should help boost consumption. Standard Chartered, a bank, says that although China’s public debt is considerably higher than the 17% of GDP officially cited, it remains manageable. Even after allowing for bad loans to local-government investment companies, it runs at 80% of GDP, the bank estimates, about the same as Britain’s last year and well below Greece’s.

Chinese leaders are perennial worriers about inflation, not least because of its role in fuelling the discontent that led to the Tiananmen Square protests of 1989. But even though it rose to 5.5% in May, considerably above the government’s 4% target for the year, it shows little sign as yet of returning to previous highs of about 20% in 1988 and more than 25% in 1994. It also has a useful political side-effect, easing some of China’s tension with America over the value of its currency. America’s Treasury says that because of the higher inflation rate in China, the yuan is in effect appreciating against the dollar by more than 10% a year. Chinese leaders have been debating whether to push interest rates higher, but Mr Kuijs says Chinese policymakers have become more tolerant of medium rates of inflation.

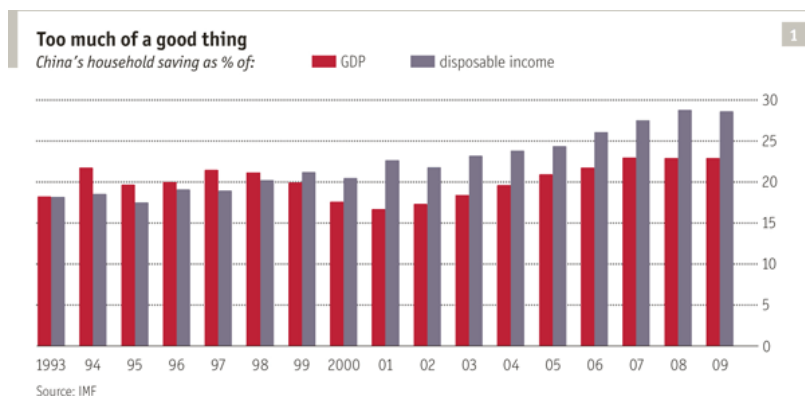
Yukon Huang of the Carnegie Endowment for International Peace, a think-tank in Washington, DC, says doomsayers are wrong to be so concerned about the fall in the ratio of household consumption to GDP. True, it has dropped from around 50% two decades ago to 35% today, among the lowest levels in the world, whereas investment is among the world’s highest; but such a decline, he says, is not unusual for an industrialising country. The efficiency of stimulus spending may be questionable, “but how efficient do you expect stimulus money to be?” He thinks growth could remain at 7-8% for a long time.

The bears’ grumbles

But many analysts are far less sanguine. Some worry that China could be approaching a Japanese-style crisis: a boom in exports and investment along with bubbly property markets, followed by many years of stagnation. In China’s case the added sting would be that it has not yet got rich. Officials and experts debate endlessly whether the country is slowly heading towards a “middle-income trap”. China was already a lower-middle-income country last year, with a GDP per person of around \$4,400. The fear is that it might suffer the same stagnation and turbulence as Latin American economies in the 1980s and 1990s.

The drafters of the new five-year plan adopted in March were clearly hoping to head off such a calamity. Five-year plans have evolved since the Mao era when they were used by the government to micromanage the economy, but they are still meant to play a crucial role in setting the economic tone. “China model” fans love them because, at least in theory, they commit leaders to an economic

strategy that will not be undermined by the chop-and-change policymaking of democracies. When Mr Wen’s successor takes over in 2013, the current plan will still have more than two years to

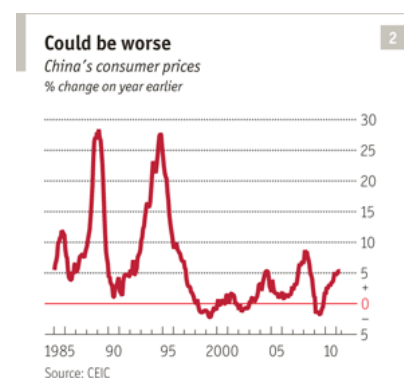


run. It calls for faster change in the “pattern of economic development” to address the imbalances, and sees boosting consumption as critical to this.

Mr Wen himself is no touter of a China model. His previous five-year plan, which took effect in 2006, was also intended to shift the economy away from too much reliance on exports and investment. It set a target of 7.5% annual growth in GDP for the plan period, against 8% for the previous one. Instead, the rate accelerated to about 11% a year, compared with an average of 9.5% in the first half of the decade. Household consumption as a proportion of GDP fell sharply. And China’s 4 trillion yuan stimulus programme (about \$620 billion at current exchange rates), launched in November 2008, allowed banks to lend almost at will, mostly to state-owned enterprises, raising the prospect of a flood of new bad debt.

Despite Mr Wen’s calls for more evenly shared prosperity, the gap between rich and poor and between cities and countryside has continued to widen. Since he took office in 2003, absolute poverty has dropped markedly. But the number of people in relative poverty (with 50% or less of the median income) grew from 12.2% of the population to 14.6% between 2002 and 2007, according to research by Terry Sicular of the University of Western Ontario and Li Shi and Luo Chuliang of Beijing Normal University. By the end of the plan period the goal of establishing a “harmonious socialist society”, a favourite catchphrase of Mr Wen’s and Mr Hu’s, appeared even more remote than at the beginning. Protests over local injustices, already running at tens of thousands a year, were becoming ever more frequent.

The new five-year plan adopted in March notes that the “external environment” for China’s development has become “more complicated”. In other words, markets abroad do not look promising. It calls for a “strategic readjustment” in China’s growth model, putting even more emphasis than its predecessor on domestic demand, especially consumption. It still envisages big investments, but in the hope that these will boost household consumption in the longer term. It promises 36m new “affordable housing” units, more than Britain’s entire housing stock. The hope is that cheaper homes will make it easier for the Chinese to get into the housing market without having to save quite so much. And the government has pledged to ramp up spending on health, education and other social-welfare programmes. Eventually too this could encourage people to save less and consume more.



The government also wants the high-speed railway network, already the world’s longest at 8,300km, to quintuple in length by 2015. Beijing, having completed one of the world’s largest airport terminal buildings in 2008, will get a whole new airport. So will 54 other cities, increasing the total number with airports by nearly one-third. These investments, officials hope, will help to boost urban growth, and with it consumption. Infrastructure targets are usually met in China because governments have little trouble with not-in-my-backyard protests.

But some economists believe this is all too much. Among the bears is Michael Pettis of Peking University, who believes that investments are becoming increasingly inefficient and that China is heading towards a “brick wall” of government debt. Growth, he says, will remain high in the early half of the decade but could drop off sharply thereafter as loans turn sour. Even in the best case, he says, growth will fall below 5%. Victor Shih of Northwestern University also points to a looming debt problem, exacerbated by the recklessness of local governments during China’s stimulus-spending spree. Not being allowed to borrow directly, many of them set up companies to borrow on their behalf, using land as collateral. “There is a hidden danger of an asset bubble and [we] are facing a certain financial risk,” wrote Yu Peiwei of the party’s Policy Research Office

in January. If the bubble bursts, land prices could plummet, leaving the banks dangerously exposed.

Bingeing on investment

Nouriel Roubini of New York University, a chronic bear, is in this camp. In a recent article he argued that the brick wall will most likely be hit between 2013 and 2015. He noted that China was spared a recession in the wake of the financial crisis because investment in fixed assets, such as transport infrastructure and factories, increased from an already very high 42% of GDP in 2008 to nearly 50% in 2010. No country, he says, could be productive enough to invest 50% of GDP in new fixed assets without eventually facing “immense overcapacity and a staggering non-performing loan problem”.

It is not just foreigners who worry. Ge Zhaoyang, a senior researcher at China Merchants Bank, gave warning in May that China’s economy had become “seriously distorted” by prolonged dependence on high levels of investment. There was now a risk, he said, of an economic downturn “unprecedented in the past 30 years” with possibly damaging consequences for China’s social and political stability.

If China is not to stagnate, it will have to make a bigger effort to persuade rural dwellers to keep coming to the cities as its population ages ever more rapidly. In 1980 one-fifth of China’s people lived in urban areas. Today the figure is 49.7%. Very soon the country will become predominantly urban, with over 51.5% forecast to be living in urban areas by the end of the five-year plan. This implies a slower pace of urbanisation than in the past decade. For once, however, the government is not setting its goals too low. In future urbanisation will indeed become harder.

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