

## THE NEW NORMAL OF CHINESE DEVELOPMENT

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### China's new transition

China's economic performance during the reform period is sometimes described as a miracle (Lin et al 1995). Its GDP per capita increased from \$220 in 1980 to \$6,000 in 2012. Not only is it now the world's second largest economy, but it also contributes at least one-third of global economic growth in recent years. China is already a major player in global markets for luxury goods, labor-intensive manufacturing exports, commodities and even foreign exchange. Many economists are optimistic that China can continue its rapid economic growth, albeit at somewhat slower pace, in the coming decades (Perkins and Rawski 2008; Lin 2011).

Structural risks, however, also grow over time, dimming China's economic outlook. Former Premier Wen Jiabao once described the growth model as 'uncoordinated, imbalanced, inefficient and unsustainable' (see, for example, Wen 2006). The structural problems include over-dependence of economic growth on external demand, continuous decline of consumption share of GDP, worsening income distribution and devastating pollution. The investment rate rose steadily from around 25 percent at the beginning of economic reform to close to 50 percent after the global financial crisis.

One consensus view shared by most economists is that this growth model needs to change in order for China's rapid economic growth to continue (Yu 2009; Huang 2010). Shortly after taking office in 2003, Wen vowed to take policy steps to improve growth quality. But general assessment is that those efforts achieved little in changing the growth model. In fact, many economists believe that the imbalance problems became worse during the past decade (Lardy 2012). Some analysts argue that correction of such structural risks necessarily requires substantially slower growth, if not collapse, of the Chinese economy (Pettis 2013):

*"China will be the last major economy to emerge from the global crisis. ... I think it is pretty clear that over the next few years China will be forced to address and reverse the high saving rate, ... This may take a decade or more. ... If the transition*

*is not mismanaged, average Chinese GDP growth rates will drop to 3% for the 2010-20 decade.”<sup>1</sup>*

In this chapter, we argue that important changes of the Chinese growth model are already underway. First, we provide evidences that the Chinese economy is transitioning toward the ‘new normal’, although this process is still at its early stage (Huang 2012). Growth potential probably lowered from 10 percent during the first decade of the 21<sup>st</sup> century to 6-8 percent during the second decade. In the meantime, current account surplus narrowed significantly; the consumption share of GDP started to rebound; and even income distribution began to improve steadily.

Second, we suggest that the primary drivers of the transition of the growth model are changes in factor markets, especially labor market. China’s economic reform approach is sometimes described as ‘asymmetric liberalization’, which completely freed up the product markets but continued with distortions in the factor markets (Huang 2010). Such cost distortions were like subsidies to the corporates but taxes on households, contributing to the imbalance, inequality and inefficiency problems as well as strong economic growth (Huang and Tao 2010; Huang and Wang 2010). Emerging labor shortage and associated rapid wage increase in recent years are largely responsible for the current transition to the ‘new normal’ with slower growth but more balanced structure.

And, third, we make some policy recommendations for the Chinese economy to complete transformation of the growth model and to avoid the ‘middle-income trap’. The next-step reforms should focus on redefining the relationship between the government and the market. The first is to complete the transition to a market economy by liberalizing the factor markets. The second is to establish macroeconomic policy frameworks that are compatible with emerging market economies. And the third is to change the government’s role from directly supporting production and investment to facilitating innovation and upgrading.

### **Slowing of GDP growth**

The Chinese economy starts to show significant transformation in recent years. These include steady downward shift of trend growth and rebalancing of economic structure. Some structural changes, such as narrowing of the current account surplus, are well documented in official statistics. Some improvements, such as rising share of consumption in GDP, are not captured by the official data. Yet some other adjustments, such as improvement in income distribution, are confirmed by official estimation but strongly rejected by many economists. We think that the structural improvements are real, driven primarily by changes in factor markets.

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<sup>1</sup> “Michael Pettis makes 12 fearless predictions about China”, April 16, 2012, *Business Insider*. (<http://www.businessinsider.com/michael-pettis-makes-12-fearless-predictions-about-china-2012-4>)

GDP growth started to decelerate in 2011, partly due to the authorities' tightening policies. Toward the end of the first quarter in 2012, however, it became clear that growth might soon fall below 8 percent level. From March that year, the government undertook a number of steps trying to stabilize economic growth, including support to on-going infrastructure projects in areas of water, power and transportation. Despite this policy effort, GDP growth decelerated continuously from 8.1 percent in the first quarter to 7.4 percent in the third quarter.

In retrospect, two special factors probably contributed to this continuous slowdown. One, export growth fell from close to 8 percent during the first half of the year to around 2 percent during July-August period. And, two, housing purchase restriction (HPR) introduced in April 2011 led to slowing of residential property investment growth to below-10 percent during the third quarter of 2012 from above-30 percent a year ago. Growth deceleration caused renewed fears of hard landing of Chinese growth among international investors. Many financial market participants repeatedly called for aggressive policy actions to support growth.

The policymakers, however, stayed relatively calm and appeared to be willing to tolerate somewhat slower growth for three reasons (Huang 2012).<sup>2</sup> First, many government officials became reluctant to adopt aggressive measures supporting growth after implementation of the 4 trillion yuan stimulus package during the global financial crisis. The package was successfully turning around economic growth in 2009. Many economists, however, argued that it increased fiscal risks, created nonperforming loans, contributed to overcapacity in some infrastructure areas and caused inflation and asset bubbles. When growth slowed again from late 2011, the policymakers were cautious not to over-stimulate the economy.

And, second, economic studies estimate China's current growth potential at 6-8 percent. The World Bank's estimates were 8.6 percent in 2011-2015 and 7 percent in 2016-2020 (WB & DRC 2012).<sup>3</sup> Cai Fang and Lu Yang (2012) estimate China's growth potential at 7.2 percent during 2010-15 and 6 percent during 2016-2020 (Figure 1).<sup>4</sup> In a recent multi-country review of growth performance, Eichengreen, Park and Shin (2011) project China to grow by 6.1 to 7.0 percent in the 2011–2020 decade and by 5.0 to 6.2 percent in the period 2021–2030.<sup>5</sup> Similarly, the joint report by the Asian Development Bank and

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<sup>2</sup> Yiping Huang, 2012, "The 'new normal' of Chinese growth", October 14, 2012, *East Asia Forum*, (<http://www.eastasiaforum.org/2012/10/14/the-new-normal-of-chinese-growth/>)

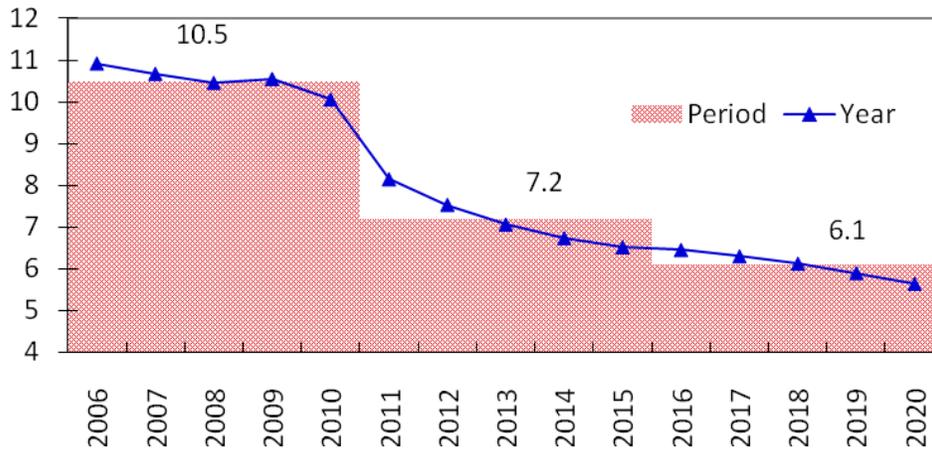
<sup>3</sup> The World Bank and the Development Research Center of the State Council (WB & DRC), 2012, *China: 2030 – Building a modern, harmonious, and creative high-income society*, March 2012, Washington D.C. and Beijing.

<sup>4</sup> Cai Fang and Lu, Yang, 2012, "At what rate can Chinese economy grow in the next 10 years?", (in Chinese) in Chen, Jiagui et al (eds.), *Chinese Economy Blue Cover Book 2012*, Social Science Literature Press.

<sup>5</sup> Eichengreen, Barry, Donghyun Park and Kwanho Shin, 2011, "When fast growing economies slow down: International evidence and implications for China." NBER Working Paper 16919.

Peking University estimates the growth potential at 8 percent in 2011-2020 and 6 percent in 2021-2030 (Zhuang, Vandenberg and Huang 2012).<sup>6</sup>

**FIGURE 1.** Estimates of growth potentials by Cai and Lu (%)



Source: Cai and Lu (2012).

And, third, economic indicators such as employment and inflation also suggested no need for aggressive policy easing, despite deceleration of GDP growth to below-8 percent levels. CPI inflation first eased, from 4.5 percent in January down to the trough of 1.7 percent in October, but then picked up slowly to above-2 percent in the following months. The labor market was also surprisingly resilient. In 2012, the economy created 12.7 million new jobs despite growth slowdown. The number of migrant workers reached 163 million, up 4.7 million from a year ago. Total number of farmers employed in non-farm jobs increased to 263 million, with an increase of 9.8 million within the year. Twenty-five provinces adjusted their minimum wages, lifting the national average by 20.2 percent. And migrant workers’ monthly wages averaged 2290 yuan or 363 dollar, up 11.8 percent from a year ago.

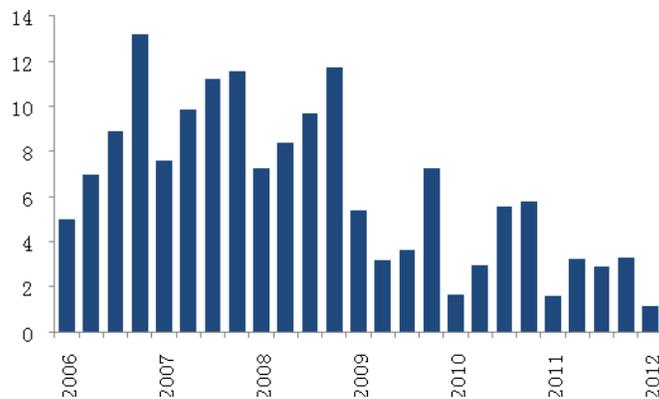
Therefore, policymakers are no longer keen in supporting above-8 percent growth. This is mainly because growth potential is already much lower, due to higher level of economic development and tightening condition of labor market. For instance, in 2012, the working-age population declined by 3.5 million. The purpose of the cautious macroeconomic policy can be viewed as a strategy to allow growth to settle around its new potential. Of course, if unemployment rate rises unexpectedly, the government likely will engage in more aggressive policies again supporting economic growth.

<sup>6</sup> Juzhong Zhuang, Paul Vandenberg and Yiping Huang, “Growth beyond low-cost advantages: Can the People’s Republic of China avoid the middle-income trap?”, October 2012, Asian Development Bank and Peking University, Manila and Beijing.

## Rebalancing of the economy

The so-called ‘new normal’, however, is more than growth slowdown. The economy also shows clear signs of rebalancing in recent years. For instance, the current account surplus narrowed from 10.8 percent of GDP in 2007 to 2.8 percent in 2011 and 2.6 percent in 2012 (Figure 2). Mainly because of this, the People’s Bank of China (PBoC) Deputy Governor Yi Gang argued that the yuan exchange rate was near equilibrium, while US President Obama’s former top economic advisor, Lawrence Summers, noted in January 2013 that the yuan was not as undervalued as it was five years earlier. In recent years, two-way movement of the exchange rate and two-directional capital flows actually started to emerge in China.

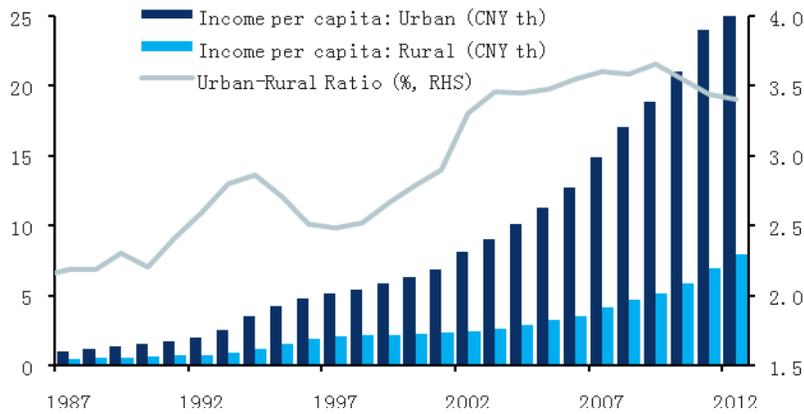
**FIGURE 2.** Current account surplus as a share of GDP, 2006-2012 (%)



**Source:** National Bureau of Statistics.

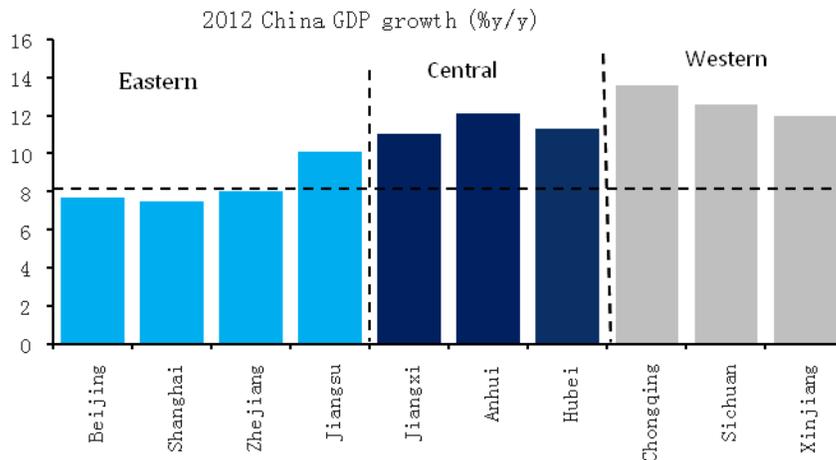
Another rebalancing in recent years relates to regional disparity, with the rural-urban income gap narrowing notably (Figure 3). This is the result of combination of stronger policy support to agriculture, faster increases in agricultural prices and steady improvement in rural productivity. In addition, China’s reform success was until recently a story of the coastal regions. However, inland economies are now growing faster than the coastal economies, thanks to the government’s ‘go west’ policy, the migration of manufacturing industries, and rich resource endowments in western China (Figure 4).

**FIGURE 3. Urban-rural income ratio narrowed, 1987-2012 (%)**



Source: CEIC Data Company.

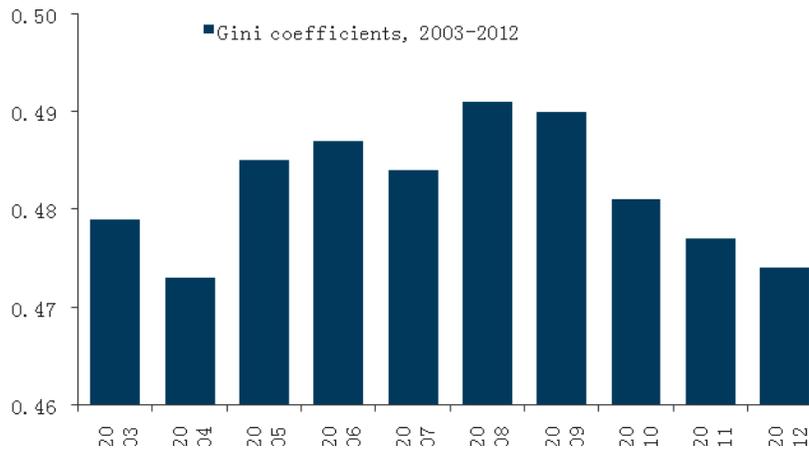
**FIGURE 4. Growth in Eastern, Central and Western China, 2012 (%)**



Source: CEIC Data Company.

In mid-January 2013, the National Bureau of Statistics (NBS) reported estimates of *Gini* coefficients for 2003-12, which show a steady deterioration of income distribution from 0.479 in 2003 to 0.491 in 2008 and steady improvement after that, to 0.474 in 2012 (Figure 5). This, if confirmed, could mark another important turning point in China’s economic development, although many Chinese economists are still skeptical about the results. For instance, a recent study by Southwest University of Economics and Finance reported a *Gini* coefficient of 0.61 in 2010. One criticism of the official NBS finding was ignorance of income equality in household wealth, such as property. Another was under-reporting of income at the high end.

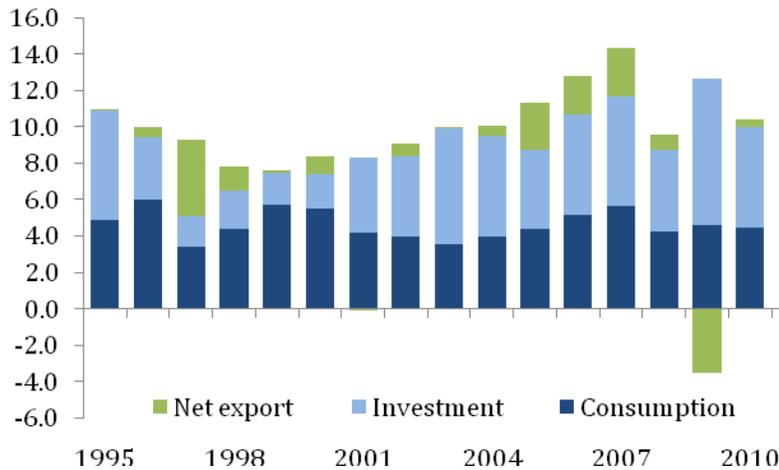
**FIGURE 5.** Gini coefficients estimated by the National Bureau of Statistics, 2003-2012



**Source:** National Bureau of Statistics.

Official data also suggest that the contribution of consumption to GDP growth increased from about one-third in 2007 to 52 percent in 2012 (Figure 6). Two Chinese economists, Tian Zhu and Jun Zhang of Shanghai, have gone further, arguing that China's consumption share is grossly underestimated as a result of underreported residential spending, consumption covered by institutional spending and technical issues in the household survey method. They note that the consumption share estimated by the Penn World Table was 60.9 percent in 2010, compared with the official figure of 47.4 percent and 58.9 percent in the Penn World Table in 1990.

**FIGURE 6.** Contribution to GDP growth, 1995-2012 (%)



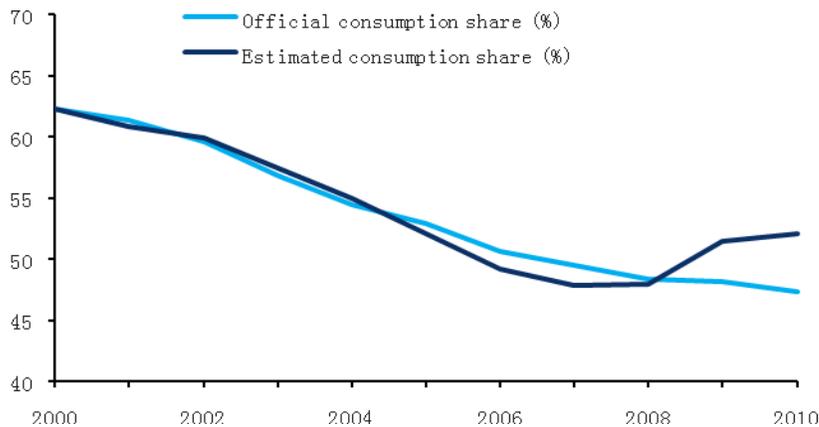
Source: CEIC Data Company.

Recent research finds that the consumption share of GDP began to rise after 2008, although this is not yet fully reflected in official statistics (Huang et al 2012 and 2013).<sup>7</sup> Huang and his collaborators find that it is difficult to reconcile accelerating retail sales and decelerating consumption in official statistics after 2008. By calculating a new growth rate for consumption, which is a weighted average of consumption-related retail sales growth and service sales growth, they reveal that the consumption share of GDP fell during much of the past decade, as suggested by official data, but rebounded from 48 percent in 2008 to 52 percent in 2010, compared with the official estimate of 47 percent in that year (Figure 7).

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<sup>7</sup> Yiping Huang, Jian Chang, Lingxiu Yang, 2013, "Recovery of consumption and rebalance of the economy in China", Asian Economic Papers, This paper was previously published as a Barclays report, *China: Beyond the Miracle - Great wave of consumption upgrading*, January 2012, Hong Kong.

**FIGURE 7.** Total consumption share of GDP estimated by Huang et al (%)



**Source:** Huang et al (2012 and 2013).

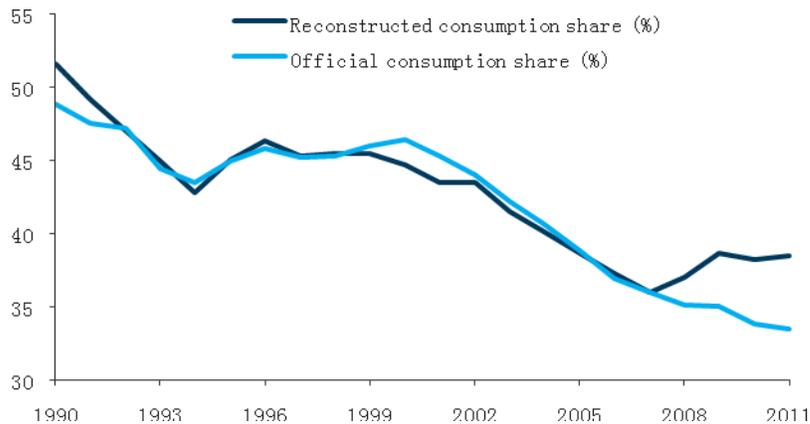
This analysis received skeptical reviews after its initial dissemination.<sup>8</sup> Some commentators find it difficult to accept our finding given their strong impression of sharply worsened structural problems following the 4 trillion yuan stimulus package adopted in late 2008. Others argue that structural improvement is impossible since the government has not undertaken more decisive reforms. However, fact that Chinese consumption is probably underestimated is shared an increasing number of Chinese economists. Li and Xu (2012), for instance, conclude in their study that household consumption share rebounded from 36 percent in 2007 to 38.5 percent in 2011 (Figure 8).<sup>9</sup>

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<sup>8</sup> Some articles criticizing findings of this study included: “Optimists’ view on China’s economy suffers from fatal flaws” (*South China Morning Post*, January 30, 2012), “China is not rebalancing a) yet, or b) enough” (Financial Times website [ft.com/alphaville's](http://ft.com/alphaville's)), “China’s rebalancing will not be automatic” (*EastAsiaForum.com*). Meanwhile, there were also articles with more sympathetic views, including “The incredible shrinking surplus: At least one of China’s economic imbalance is narrowing” (*The Economist*, February 18, 2012.) and “All hail the Chinese shopper” (*Financial News*, February 27, 2012. <http://www.efinancialnews.com/story/2012-02-27/hail-the-chinese-shopper>).

<sup>9</sup> David Li and Sean Xu, 2012, “The rebalancing of the Chinese economy”, CCER-NBER Conference on the Chinese economy, Peking University, June 25-26, 2012, Beijing.

**FIGURE 8.** Household consumption share of GDP estimated by Li and Xu (%)



Source: Li and Xu (2012).

### Driving forces behind the new normal

Slower but more sustainable economic growth and more balanced economic structure are key features of what we call the ‘new normal’ of Chinese economic development. Although the government made serious efforts during the past decade, the key factors driving the transition of the Chinese economy are changes in the factor markets, especially in the labor markets. Emerging labor shortage leads to rapid increase in wages, which, in turn, slows economic growth, raises inflation pressure, improves income distribution, rebalances economic structure and accelerates industry upgrading (Huang et al 2011).

Economists have developed various analytical frameworks to explain changes in the Chinese economy during the past decades. Justin Lin, Cai Fang and Li Zhou argue that the key to the success was the transition from the heavy industry-oriented to comparative advantage-oriented development strategy (Lin et al 1995).<sup>10</sup> Barry Naughton introduces the term ‘growing out of the plan’ to describe China’s incremental growth of the market-oriented, private sector, while maintaining support to the old state-owned enterprises (Naughton 1995).<sup>11</sup> Jeffery Sachs and Wing Thye Woo, however, point out that Chinese economic success can be explained mainly by its convergence to the typical market system of East Asia (Sachs and Woo 2000).<sup>12</sup>

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<sup>10</sup> Justin Lin, Cai Fang and Li Zhou, 1995, *The China Miracle: Development Strategy and Economic Reform*, The Chinese University of Hong Kong Press, Hong Kong, 1995.

<sup>11</sup> Barry Naughton, 1995, *Growing Out of the Plan: Chinese Economic Reform, 1978-1993*, Cambridge University Press, 1995.

<sup>12</sup> Jeffrey D. Sachs and Wing Thye Woo, 2000, “Understanding China’s economic performance”, *Journal of Policy Reform*, 2000, Volume 4, Number 1, pages 1-50.

Despite the differences in their angles and perspectives, these economists all appear to agree that the key of the reform is the transition from a centrally planned to a market system. This is certainly correct but may only be part of the story. In a series of recent research papers, we argue that the fundamental reason behind the combination of strong economic growth and increasing structural risks is China's *asymmetric market liberalization* approach (Huang 2009 and 2010; Huang and Tao 2010; Huang and Wang 2010). Free markets for products ensure that production decisions are based on demand and supply conditions in the economy, and resources are allocated efficiently. Distortions in factor markets are a way of providing incentives for economic entities and, sometimes, overcoming market failures.

Factor market distortions include the household registration system limiting labor mobility between rural and urban areas, direct controls of bank deposit and lending rates, set of energy prices, especially oil prices, by state agencies and offering discounted land use fee to investors. In most cases, these distortions depress input costs. However, labor is a special case, as it is unclear if labor market segmentation lowers or increases labor cost. But labor cost was low for a long time because of abundant agricultural labor or unlimited labor supply in a typical Lewis dual-economy.

The low input costs, including low labor cost, are like subsidies to the companies but taxes on the households. They boost profits from production, increase returns to investment and improve international competitiveness of Chinese exports. Low input costs also serve as a special mechanism redistributing income from households to the companies. Over the years, corporate profits grew much faster than household income, as household income was largely capped by stagnant wage rate.

Over time, they also contribute to the structural problems. One, the extraordinary incentives lead to continuous rise of the shares of exports and investment in GDP. Two, rise of the share of corporate profit in national income increases the national saving rate, as corporate saving rate is generally higher than household saving rate. Three, income inequality among household deteriorates as low-income households rely more on wage income while high-income households rely more on corporate profits and investment returns. Four, consumption share of GDP declines over time as household income grows slower than GDP. And, five, the unusually low costs of energy, capital and other resources probably also resulted in some waste behavior.

The recent transition to the 'new normal' of Chinese economic development is primarily attributable to changes in factor markets, among some other factors. In a recent study, Huang et al (2011) argue that the distorted factor costs already started to change.<sup>13</sup> Labor market shows clear signs of supply shortage, evidenced by accelerating wage increases in recent years (Figure 9). Development of shadow banking businesses also

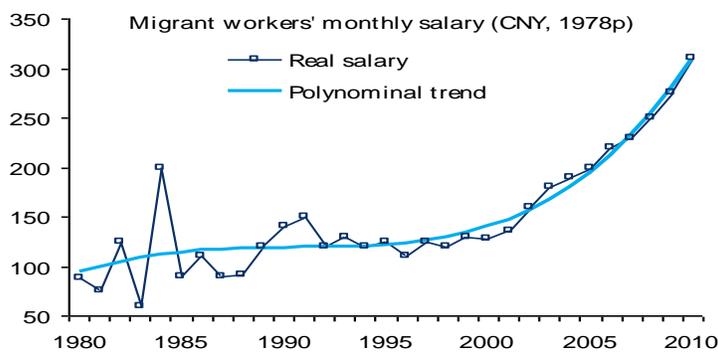
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<sup>13</sup> Huang Yiping, Chang Jian and Steven Yang, 2011, *China: Beyond the miracle – China's next transition*, September 2011, Barclays, Hong Kong.

opens the door for 'de facto interest rate liberalization'. The government has also been trying to reform prices of energy, water and other resources.

The so-called Lewis turning point (LTP) – the transition of the labor market from surplus to shortage – has particularly important implications for China's macroeconomy (Huang and Cai 2010). Rapid wage growth, especially that at the lower end of the market, cuts into profit margin. Therefore, it reverses past redistribution of income from households to corporates. As these implicit subsidies for Chinese companies are reduced, export and investment activities soften and, therefore, the economy rebalances. Applying a computable general equilibrium model of the world economy, Huang and Jiang (2010) analyze detailed economy-wide consequences of the LTP in China.

**FIGURE 9.** Migrant workers' wages have been rising rapidly



**Source:** Lu Feng, 2011, "Employment expansion and wage growth (2001-2010)", China Macroeconomic Research Center, Peking University, Beijing, 12 June 2011.

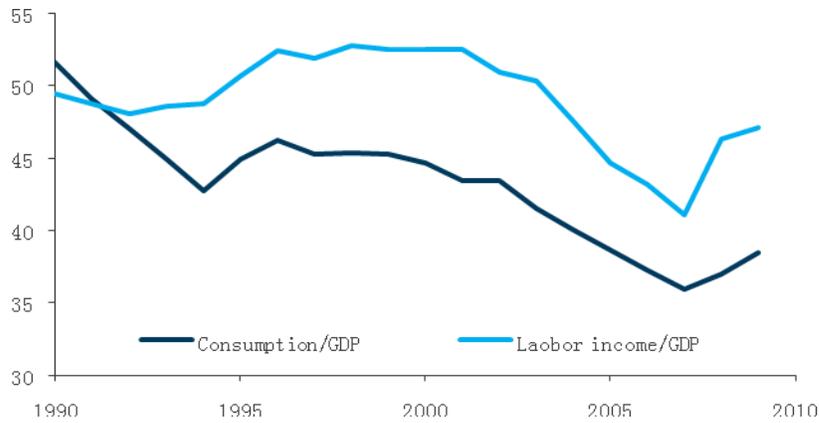
Perhaps it is relatively easy to understand why growth potential declines in recent years. It is a universal phenomenon that growth slows as an economy develops. This is because narrowing gap from the world technological frontier means less advantages of backwardness (Lin 2012).<sup>14</sup> But the growth slowdown is accelerated in China by changing demographics, including labor shortage and falling working age population. For the same reason, rapidly increasing wages also create inflation pressure, as rising costs can only be absorbed by higher output price, narrower profit margin or faster productivity growth or a combination of the above.

So, what contribute to rising consumption share of GDP in recent years? The answer is household income. When an 'unlimited labor supply' exists, rapid industrialization is accompanied by a stable wage rate and, therefore, a declining share of wage income in GDP. This is reversed when a labor shortage emerges: wages rise rapidly and the share of wage income in GDP starts to grow. In fact, labor income also picked up from 41 percent in 2007 to 47.1 percent in 2009 (Figure 10), which, in turn, boosted consumption relative to GDP. This was also exactly what happened in Korea and Taiwan

<sup>14</sup> Justin Lin, 2012, *The Quest for Prosperity: How developing economies can takeoff?* 2012, Princeton University Press, Princeton.

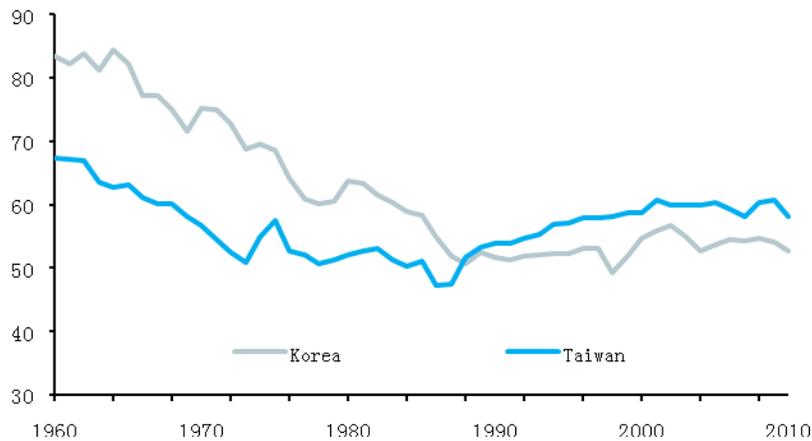
in the mid-1980s, when their consumption shares started to recover following their respective LTP (Figure 11).

**FIGURE 10.** Labor income and consumption share of GDP by Li and Xu (%)



Source: Li and Xu (2012).

**FIGURE 11.** Private consumption share of GDP in Korea and Taiwan (%)



Source: CEIC Data Company.

Rapid wage growth was probably also behind the recent improvements in income distribution highlighted by the NBS, since low-income households rely more on wage income and high-income households rely on investment returns or corporate profits. If the past trend was households subsidizing corporations, then the new trend is redistribution of income from corporations to households as rising labor costs increase wage income but squeeze corporate profits. This is probably why, in rapidly developing economies, the so-called Kuznetz turning point (when income distribution shifts from deteriorating to improving) often follows the Lewis turning point (Huang and Cai 2010).

## What's next?

Clearly, rebalancing is still at an early stage. For instance, the consumption share of GDP, at 52 percent in 2010, on our estimates, was significantly below the 70-90 percent range in most developing and developed economies. This gap may be narrowed, in part, through continuous wage adjustment. Expected interest rate liberalization, which will likely lead to high deposit rates, at least, should further facilitate rebalancing. Further changes may also be required to transform the development pattern completely. This could involve measures to improve income equality beyond the primary round of income distribution, development of social welfare systems such as pension, medical insurance and education, and financial and capital account liberalization.

The first wave of cost shocks – increases in wages – already caused significant economic restructuring. The labor-intensive manufacturing industry in the coastal region is either moving to the western provinces, or migrating to other low-cost countries or upgrading along the value chain. Given rapid increases in production costs in inland provinces, China will likely lose its labor-intensive industries, especially those export-oriented sectors, faster than many anticipate.

The second wave of cost shocks – increases in costs of capital and energy – may bring about more profound changes to the Chinese economy. Again, normalization of these costs could reveal massively misallocated resources in the Chinese economy, especially in heavy and highly leveraged industries. Most of these companies are state-owned and were built on distorted incentive structure. Once costs of capital and energy rise, some of these seemingly profitable companies may become financially unviable. And this would inevitably lead to major industry consolidation, which might bring the first recession to the Chinese economy since the beginning of its economic reform.

However, we do not think this would be the beginning of a period of growth stagnation as some suggest (see, for instance, Pettis 2013). Taking financial repression as an example, it certainly lowers cost of capital in the formal sector, especially for the SOEs. But it at the same time also raises cost of capital outside of the formal sector. Therefore, normalization of cost of capital could result in temporary shrink of economic activities in the state sector. At the same time, it might also boost economic activities of the non-state sectors by improving their access to credit and reducing their cost of capital. Importantly, the non-state sectors now account for almost 80 percent of total industrial output.

Successful transition to the 'new normal' of economic development is only a first step in China's long march toward a high-income country. A bigger challenge facing the Chinese economy now is the so-called 'middle-income trap', as its GDP per capita reaches high middle-income level and its labor cost rises rapidly. The 'middle-income trap' may be defined as the situation in which when an economy loses competitiveness in low value-added industries but fails to move up to high value-added industries (Zhuang, Vandenberg and Huang 2012). Chinese industries are already under significant pressure as the three important conditions that facilitate their extraordinary growth in the past –

unlimited labor supply, low-cost advantage and rapid export expansion – all diminish steadily. According to the World Bank, only 13 out of 88 middle-income economies succeeded during the past half-century in making the jump to high-income economies (World Bank 2012).

Skepticisms about China's ability to continue relatively rapid economic growth are based on several concerns. One main worry is its unsustainable growth model. If the imbalance, inefficiency and inequality problems are not reversed quickly, they could seriously dampen outlook of the Chinese economy. Unfortunately, as some analysts argue, the policy efforts trying to improve growth quality achieved little, at least according to the official statistics (Lardy 2012).<sup>15</sup> Others believe change of the growth model is possible but it necessarily requires substantially slower growth (Pettis 2013).<sup>16</sup>

Another concern relates to the lack of progress in political reform, alongside market-oriented economic reform. This pattern of reform has led to what Wu Jinglian calls 'state capitalism'.<sup>17</sup> To a large extent, this explains the growing problems of monopoly, corruption and disparity. The SOEs, for example, are a typical example of extractive institutions – they extract monopoly profits by controlling cheap inputs and prohibiting entry by others. More importantly, China might be locked into following this path, as it will be hard to reverse course except through extreme social turmoil. Without necessary political reforms to improve political and economic institutions, the Chinese growth would sooner or later collapse (Acemoglu and Robinson 2012).<sup>18</sup>

A third difficulty is Chinese industry's ability to innovate and upgrade. So far, Chinese growth has been driven mainly by low-cost advantage, increasing input and productivity gain through resource reallocation, such as rural-urban migration. But growth based on resource mobilization is, by definition, not sustainable (Krugman 1994).<sup>19</sup> But can technological innovation replace resource mobilization to become the main driver of economic growth in China? One obvious hurdle is the low education level of hundreds of millions migrant workers. If they lose low-skills manufacturing and construction jobs, they might not be able to work in high technology and high value-added sectors. Foreign companies also complain that the environment is not conducive to technological innovation because of lack of proper protection of intellectual property rights in China.

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<sup>15</sup> Nicholas R. Lardy, 2012, *Sustaining China's economic growth after the global financial crisis*, Peterson Institute of International Economics, Washington DC.

<sup>16</sup> Michael Pettis, 2013, *Great rebalancing: Trade, conflict, and perilous road ahead for the world economy*, Princeton University Press, Princeton.

<sup>17</sup> "Fast-track China is on the wrong path", (An interview with Wu Jinglian by Hu Shuli), *The Wall Street Journal*, Asia Edition, July 28, 2011. (<http://online.wsj.com/article/SB1000142405311904800304576471393143140106.html>)

<sup>18</sup> Daron Acemoglu and James A. Robinson, 2012, *Why nations fail: The origins of power, prosperity and poverty*, 2012, Crown Publishers, New York.

<sup>19</sup> Paul Krugman, 1994, "The myth of Asia's miracle", *Foreign Affairs*, November/December 1994, 73(6): 62-78.

We think these three concerns are real issues but should not be overstated. As we discussed above, rebalancing of the Chinese economy is already underway, although it is not fully appreciated by investors and economists. Completion of rebalancing of the Chinese economy is subject to both further liberalization of factor markets and additional policy reforms to improve growth quality.

Political reform will be necessary to eradicate corruption and maintain political stability. But we doubt that China will adopt western style democracy any time soon and that the current political regime has already exhausted the growth potential. Institutions matter for long run growth. But perhaps optimal institutions are different for economies at different stages of development. The post-war experiences of imposing developed economies' institutions on developing countries, such as the Washington Consensus, were largely unsuccessful. One important reason could be that technological innovation and technological catch-up require different types of institutions – with GDP per capita at \$6,000, China still has huge potential to gain through technological catch-up.

Even in terms of innovation, China has been doing well. It saw science & technology takeoff much earlier than most other developing countries – its share of R&D expenditure of GDP reached 1% when its GDP per capita was only \$3,000 while an average developing countries reached the same level of R&D expenditure when its GDP per capita was \$8,000. Globally, China is already a leader in terms of total R&D spending, patent filing and R&D productivity (measured by number of patent filing divided by R&D expenditure). Continuous technological innovation and industry upgrading are also observed in a large number of industries including automobiles, large machineries and information technology. Protection of intellectual property rights (IPR) is a key drag. But China already has a nationwide IPR court system and the number of IPR cases is increasingly rapidly. According to international experiences, IPR protection likely will strengthen significantly indigenous innovation becomes a dominant phenomenon.

One major difficulty is to improve labor quality or human capital. As China moves toward high-income country, industrial upgrading will likely shift employment from labor-intensive to capital-intensive to technology-intensive sectors continuously. The Chinese experiences suggest that shifting workers from labor-intensive to capital-intensive sectors in the secondary industry requires, on average, 1.3 years additional education. Workers shifting further to technology-intensive sectors in tertiary industry require 4.2 years' additional education, on average. However, human capital accumulation can take place only gradually. For instance, the average number of years of education for the population aged at 16 years and above increased from 6.24 years in 1990 to 7.56 years in 2000, a net increase of 1.32 years. It further increased to 8.9 years in 2010, another net increase of 1.34 years.

Currently, China has a total of 260 million migrant workers, most of whom only finished junior high school. As wages rise rapidly, whether or not these migrant workers will be able to find employment in higher value-added industries will be a critical test for China's "middle-income trap" challenge. If not, China may end up in not only growth

stagnation but also massive unemployment problems. Therefore, improving labor quality through education and training should be a policy priority in the coming decades.

### Policy implications

Market-oriented economic reforms have been incomplete in China. In our view, this, particularly the widespread distortions to factor costs, contributed to both success in economic growth but problems such as structural risks. Recent changes in factor markets, including emerging labor shortage and rapid wage increase, already slow economic growth and rebalance economic structure, both of which are key features of 'new normal' of economic development.

This rebalancing trend should not be mixed with some cyclical changes. For instance, while the overall trends are for the investment share of GDP to moderate while the consumption share of GDP to rise, at the beginning of 2013, this looks reversed again. The government's policy to stabilize growth inevitably boosts growth, as infrastructure spending is the only swing factor in the near term. Nevertheless, the target is much lower. At the same time, consumption, especially high-end consumer spending, is negatively affected by the government's campaign to crack down on corruption.

These temporary disturbances should not reverse the overall rebalancing trends, unless the government pushing for investment-led growth again. We don't think this will happen. But the risk is real. The new government is keen to accelerate urbanization process, which could possibly mean a lot more investment. In the meantime, local governments are all planning on massive investment programs again. Local investment programs, however, are mainly constrained by their funding capabilities. It's critical for Beijing to keep the brakes on local and central investment programs in order for the rebalancing process to continue.

But this itself is not sufficient. Further policy reforms may be necessary to complete the transition toward the new normal and to avoid the 'middle-income' trap. Former President Hu Jintao suggested that reforms in the next stage should be organized around the central theme of redefining the relationship between the government and the market (Hu 2012).<sup>20</sup> In our view, this could include important policies in the following three areas. First, if China had a no-market economy during the pre-reform period and a half-market economy during the first three decades of the reform period, it is now time to complete the transition to a market economy by removing all the remaining distortions, especially those in factor markets.

Second, China needs to establish a macroeconomic policy framework compatible with an emerging market economy, including an accountable budget system and professional monetary policymaking mechanism. China's macroeconomic policy framework remains

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<sup>20</sup> Hu, Jintao, 2012, "Firmly march on the path of socialism with Chinese characteristics and strive to complete the building of a moderately prosperous society in all respects", Political Report delivered at the 18<sup>th</sup> National Party Congress, November 8, 2012, Beijing.

administrative in nature. For instance, many of the problems associated with the 4 trillion yuan stimulus package was not the central government's expansionary policy but investment programs supported or implemented by the banks, the SOEs and the local governments.

And, third, the government's role should shift from directly supporting production and investment through resource mobilization to facilitating innovation and upgrading via supporting physical and soft infrastructure development. These could include better support to the country's education and research system and improve IPR protection. A critical test in the perceivable future is to upgrade the skills of large number of migrant workers, most of whom have less than seven years school. It is important to devise training programs so that these workers may be able to move to new industries when their current employers are phased out by rapidly rising costs.

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