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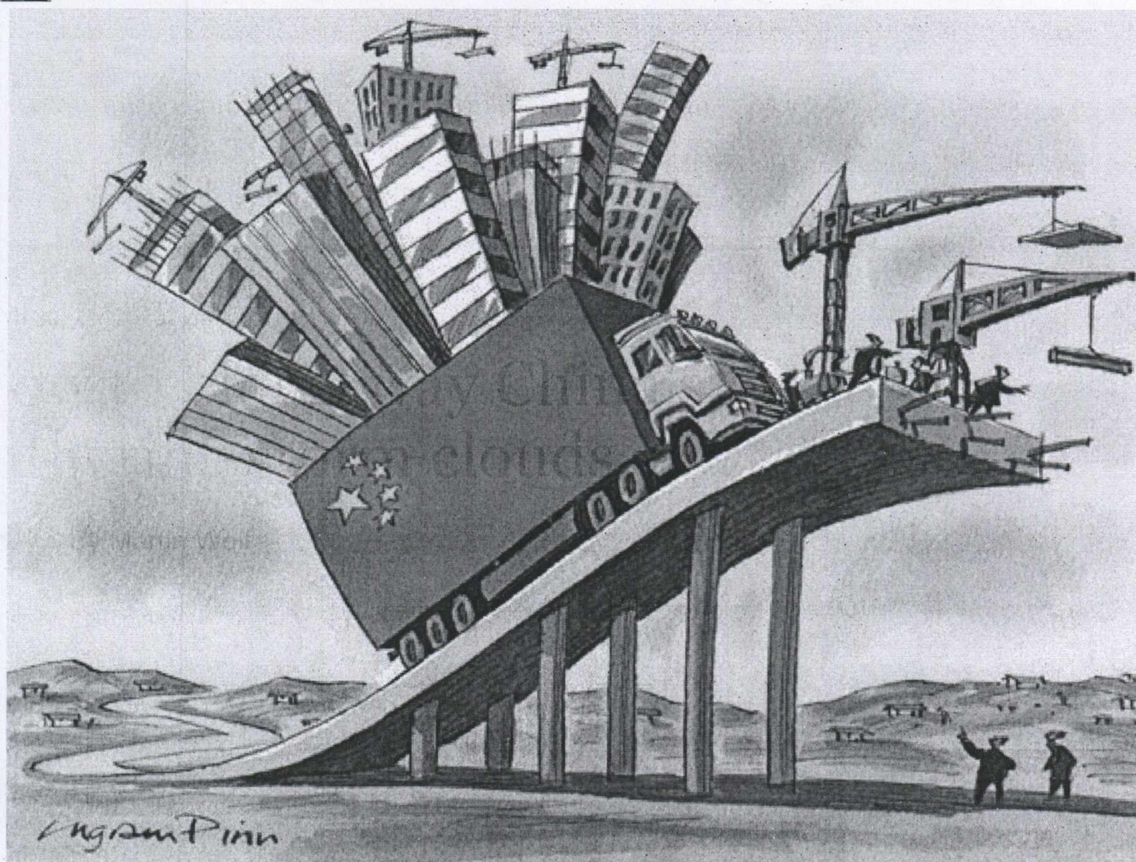
How to blow away China's gathering storm clouds

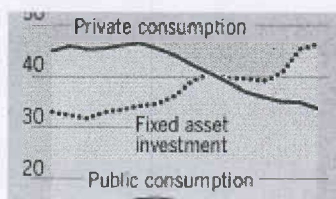
By Martin Wolf



China is entering upon a difficult transition to both lower growth and a different pattern of growth. This is the conclusion I drew from this year's China Development Forum in Beijing. Moreover, it is likely to be a political as well as an economic transition. These two transitions will also interact with one another in complex ways. The past record of economic success, under Communist party rule, does not guarantee a comparably successful future.

Readers do not need to take my word. They can take those of the outgoing premier, Wen Jiabao, who said on March 14: "The reform in China has come to a critical stage. Without the success of political structural reform, it is impossible for us to fully institute economic structural reform. The gains we have made in reform and development may be lost, new problems that have cropped up in China's society cannot be fundamentally resolved and such historical tragedy as the Cultural Revolution may happen again."

These political questions are of great importance. But the economic transition, in itself, will be hard enough. China is coming to the end of what economists call "extensive growth" – driven by rising inputs of labour and capital. It must now move to "intensive growth" – driven by



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improving skills and technology. Among other consequences, China's rate of growth will slow sharply from its average annual rate of close to 10 per cent of the past three decades. Making this transition harder is the nature of China's extensive growth, particularly the extraordinary rate of investment and heavy reliance on investment as a source of demand (see charts).

China is ceasing to be a labour surplus country, in terms of the development model of the late West Indian Nobel laureate, Sir Arthur Lewis. Lewis argued that the subsistence income of surplus labour in agriculture set a low ceiling for wages in the modern sector. This made the latter extremely profitable. Provided the high profits were reinvested, as in China, the rate of growth of the modern sector and so of the economy would be very high. But, at some point, labour would become scarcer in agriculture, so raising the price of labour to the modern sector. Profits would be squeezed and savings and investment would fall as the economy matured.

The China of 35 years ago was a surplus labour economy. Today that is true no longer, partly because growth and urbanisation have been so rapid: since the beginning of reform the Chinese economy has grown more than 20-fold, in real terms, and half of China's population is now urban. In addition, China's low birth rate means that the working age population (15-64) will reach a peak of 996m in 2015. A paper by Cai Fang of the Chinese Academy of Social Sciences states that "labour shortage has become rampant throughout the country since it broke out in coastal areas in 2004. In 2011, manufacturing enterprises came across unprecedented and universal difficulties in recruiting labour". Mr Fang's paper gives compelling evidence of the consequent rise in real wages and shrinking profits.

China is now at the Lewis turning point. One consequence is that, at a given investment rate, the ratio of capital to labour will rise faster and returns also fall faster. Indeed, strong evidence of such rising capital intensity emerged even before the Lewis turning point. According to Louis Kuijs, a former World Bank economist, the contribution to higher labour productivity of the rising ratio of capital to labour (as opposed to the contribution of a higher "total factor productivity" (TFP), or overall productivity) rose from 45 per cent between 1978 and 1994 to 64 per cent between 1995 and 2009.

This has to change. China's growth must be driven by rising TFP, which will sustain profits, rather than rising ratios of capital to labour, which will lead to declining profits, particularly now that real wages are rising fast. Some decline in profits is desirable, given the maldistribution of income. Taken too far, it would damage potential growth.

The difficulty of making the transition to growth driven by technical progress is one reason why so many countries have fallen into what has come to be called the "middle-income trap". China, now a middle-income country, is determined to become a high-income country by 2030. That will take deep reforms, which are laid out in a remarkable recent joint report by the World Bank and the Development Research Center of the State Council. Those reforms will adversely affect vested interests, particularly in local government and state-owned enterprises. That is surely a big reason why Mr Wen thinks political reforms matter.

The need to make difficult reforms, to sustain growth in the next two decades, is China's longer-term challenge. In trying to get there, it confronts the short-term risks of a hard landing, as Nouriel Roubini of the Stern School of Business at New York University pointed out at the conference. China's government is targeting annual growth of 7.5 per cent this year and of 7 per cent in the current five-year plan period. Some such slowdown seems inevitable. As growth slows, the need for extraordinary investment rates will also decline (see chart).

Yet getting from an investment rate of 50 per cent of gross domestic product to one of 35 per cent, without a deep recession on the way, requires an offsetting surge in consumption. China has no easy way to engineer such a surge, which is why its response to the crisis has been still higher investment. In addition, China has come to rely heavily on investment in property construction: over the past 13 years investment in housing has grown at an average annual rate of 26 per cent. Such growth will not continue.

China may indeed manage the transition to a very different kind of economic growth. The country still has vast potential to catch up. But the challenges of adjusting to the new pattern will be huge. Plenty of middle-income countries have failed. It is difficult to argue against China, given past successes. The best reason for confidence is that top policy makers lack such complacency.

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