FOR PROFESSIONAL INVESTORS – 24 July 2019

Chi on China

CHINA'S GROWTH BEYOND THE MIDDLE-INCOME TRAP

We know what we are, but know not what we may be.

William Shakespeare

SUMMARY

- China could avoid falling into the middle-income trap if it could break the economic constraints of population, capital and productivity on growth. But can it realistically do that and what will it look like in the post-middle-income environment?
- Consumption-led growth and industrial upgrading will be two of the key emerging themes for China's structural change story in the next 30 years when President Xi Jinping's "Chinese Dream" is supposed to yield some tangible results.
- The structural switch from quantity to quality growth has just begun. The ultimate question is who will benefit from China's transition to a high-income, high-tech and consumption-led economy from being the world's factory?

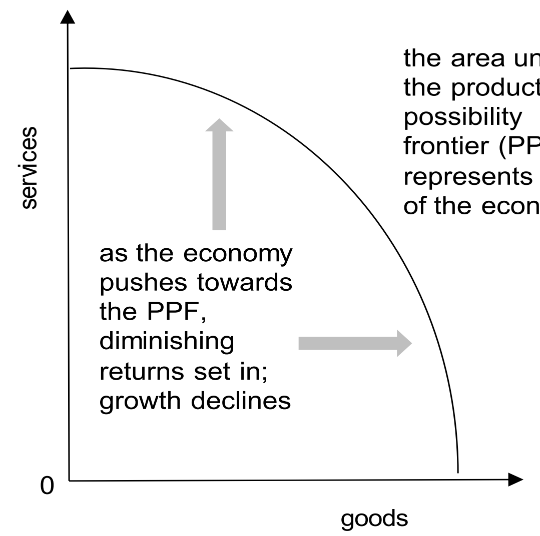
China's annual GDP growth has fallen from double-digit rates between 1980 and 2012 to around 7% since President Xi Jinping took office in 2013. Growth is now expected to fall below 6% in the coming years. This declining trend seems to vindicate warnings of the dreaded middle-income trap – the tendency of fast-growing developing economies to revert to a much weaker growth trajectory, and stagnate when per capita income approaches the upper bound of the middle-income range between USD6,000 and USD12,000 a year, according to the World Bank. China's per capita income in 2018 was already USD10,200.

Economic growth is a function of the two factors of production – labour/population and capital – and a residual factor – productivity. When a country grows towards its production possibility frontier (PPF)[1] which defines the

[1] A production possibility frontier is a curve that shows all the possible combinations of output for two products that can be produced using all factors of production, where the given resources are fully and efficiently utilised.

size of the economy, diminishing marginal returns set in (Chart 1). If there is no growth in productivity, overall economic growth will stagnant and eventually decline.

Chart 1: Production possibility frontier



source: BNPP AM (Asia)

GROWTH CONSTRAINTS – RELAXED?

Whether China can break out of the middle-income trap and move to a high-income economy depends on its labour, capital and productivity constraints. Relaxing these constraints can increase the size of the economy. What is little known about China's ageing population problem is that it may not bite for another 20 years. So labour may not be a growth constraint as commonly believed.

There are natural demographic dynamics for expanding China's labour force to counteract its contraction[2] under the prevailing static framework. China can easily find more than 200 million workers in the next 20 years to offset the expected loss of 200 million workers between 2030 and 2045 through urbanisation and changes to the retirement and regional migration policies[3].

Furthermore, if China could boost its 68.4% labour participation rate to Japan's 79%, for example, its labour force would increase by 26% (or 162 million). Successful industrial restructuring will lead to higher labour 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 urbanisation rates will add to these forces. Crucially, industrial migration towards the inland (Chart 2) will also add to growth by tapping cheaper resources and spreading income growth more evenly across the country[4].

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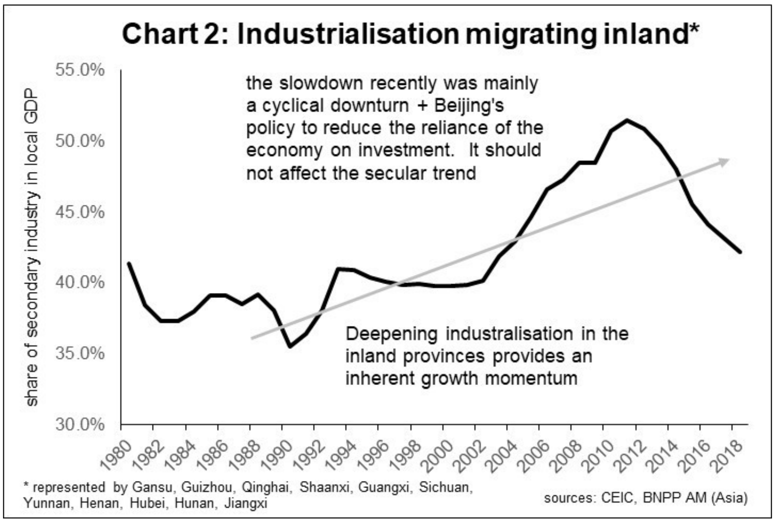
[2] There were 250 million 0-15 year-olds in 2018. They will be in the labour force in 16 years. If we assume the urban/rural distribution of this age cohort follows the national distribution, where 41% of the population is rural, in the next 16 years these 100-million-plus (250 x 41%) people can be urbanised. Further urbanisation of the adult rural population (15-64 years old), estimated at 402 million in 2018, will augment the labour force in the coming years. Assuming half of this population was aged between 15 and 30 in 2018, there will be more than 200 million of the rural working-age population that can be urbanised in the next 20-plus years.

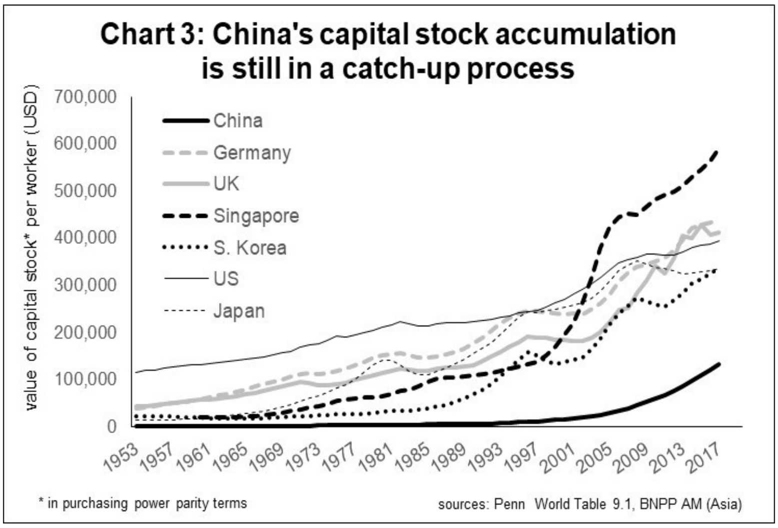
[3] See "*Chi on China: What Don't We Know About China's Demographic Pains?"* 22 May 2019.

[4] See "*Chi on China: Progress on China's Structural Rebalancing and Reverse Migration*", 8 November 2017.

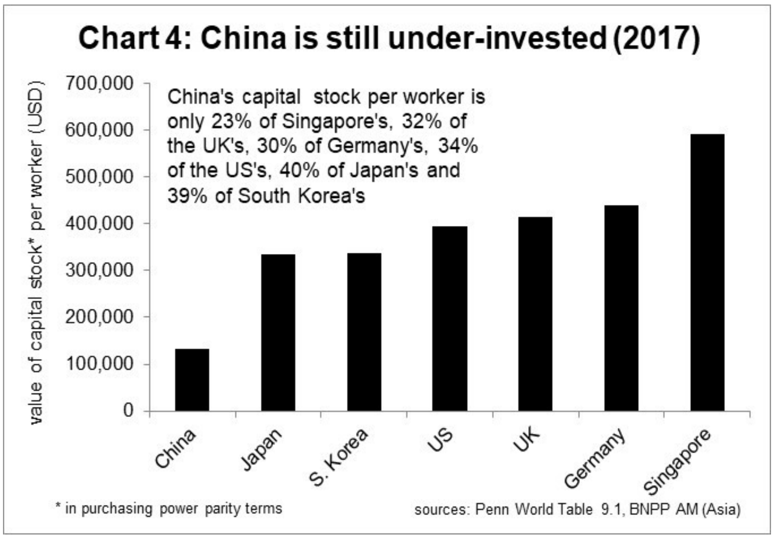


Capital also does not seem to be a growth constraint for China in the medium- to long-term, despite the existence of excess capacity. China only started building up capital in the late 1980s while most of the other major economies started in the 1950s (Chart 3). Even after 40 years of catching up, its capital stock per worker is still significantly less than the major economies and its Asian peers (Chart 4).

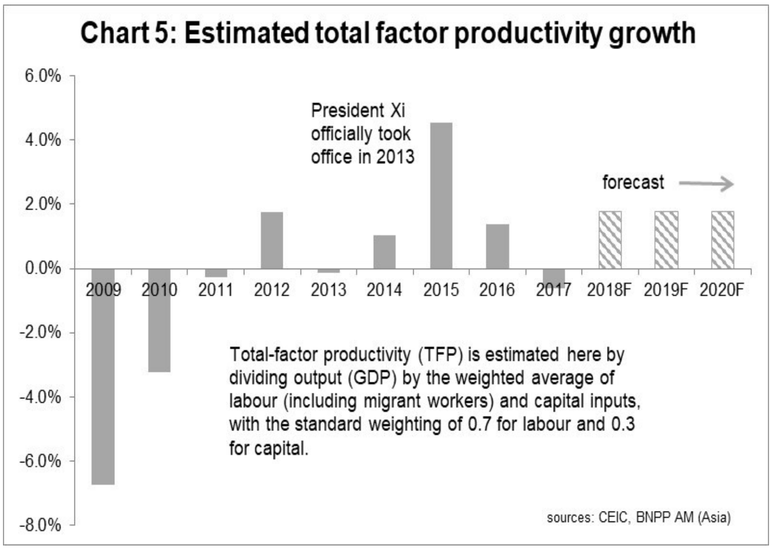
There is a conundrum that China suffers from under-investment as well as excess capacity[5]. The coexistence of these two conflicting forces lays bare a serious structural flaw of capital misallocation. It argues that China's economic inefficiency was not due to too much investment but to the state sector's soft budget constraint that misallocated capital to a few giant inefficient state industries. They have created excess capacity that has dominated the economy and stymied private-sector "animal spirits", resulting in under-capitalisation in other parts of the system.



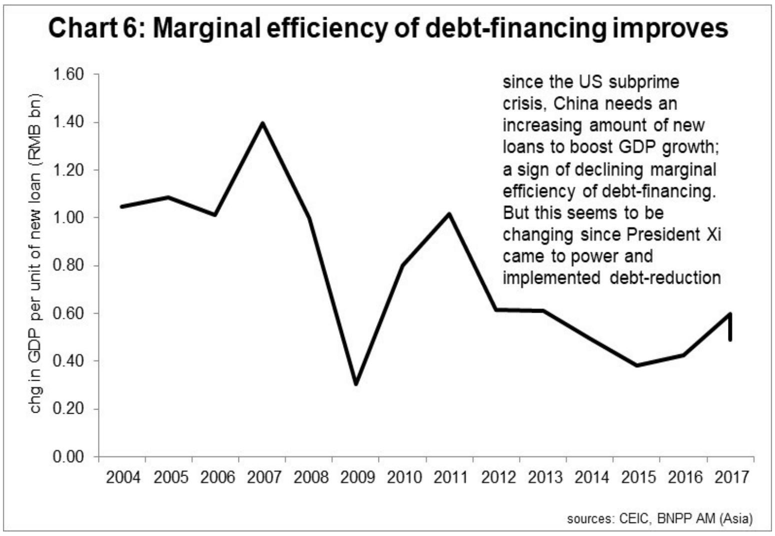
[5] See "*Chi on China: The Conundrum of China's Excess Capacity*", 14 September 2016.



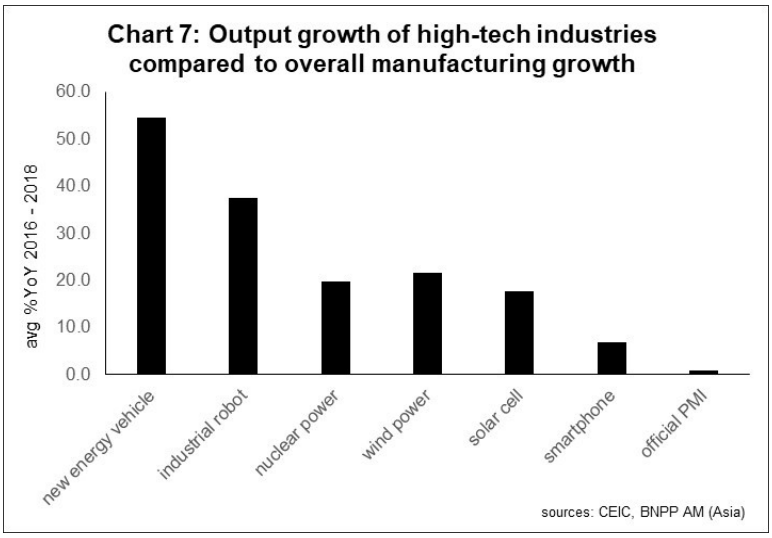
Meanwhile, China's total factor productivity (TFP)[6] growth seems to be recovering from the decline in recent years (Chart 5) under President Xi's "new normal" policy, which aims at keeping GDP growth at a moderate 6.0% - 7.0% range and implementing structural reforms and paring debt. Previous debt-fueled excess investment led to sluggish or decline in productivity growth. The new normal policy has shown some initial success with rising marginal efficiency of debt-financing (Chart 6) implying an improvement in the GDP growth quality.



[6] Total-factor productivity (TFP) is the amount of output produced by the combined inputs of labour and capital. It is estimated here by dividing output (GDP) by the weighted average of labour (including migrant workers) and capital inputs, with the standard weighting of 0.7 for labour and 0.3 for capital.



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 out-performed overall economic growth significantly (Chart 7). China's aim to become a technology powerhouse by 2050 should help raise productivity growth.



ESCAPING THE MIDDLE-INCOME TRAP

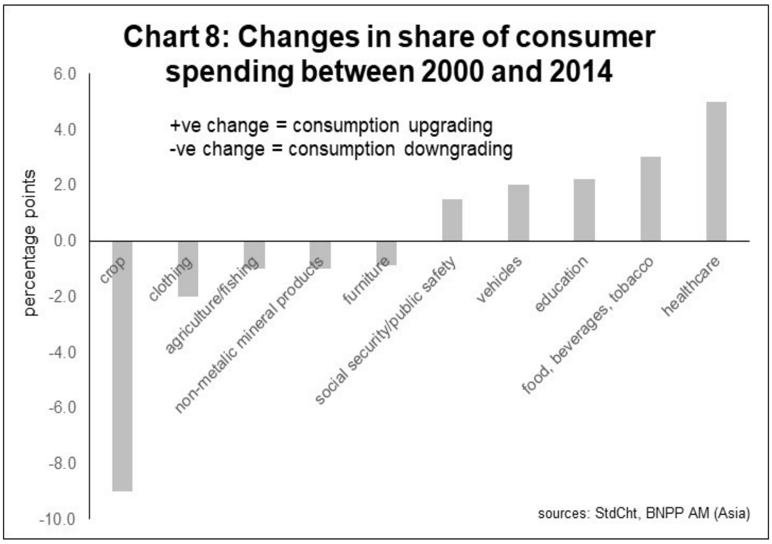
If labour will not be a growth constraint for another 20 years, capital will continue to accumulate and productivity growth will revive under the new technology-focused development policy, China's PPF can be pushed out, i.e. the size of China's economy can be expanded. Even if China's per capita GDP grows by an average of only 5.0% a year for the next decade, its per capital income will breach the USD12,000 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 USD6,000 to USD12,000 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 USD12,000 level, consumer demand will move into even higher value-added goods and services, including education, healthcare, financial services and assets[7].

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?

THE FUTURE WINNERS

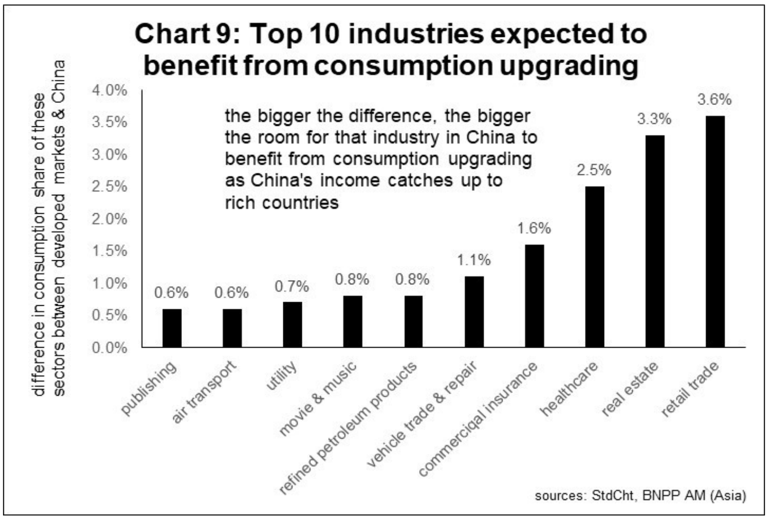
Data from a recent industry study[8] gives us some basis for assessing the major beneficiaries. Chinese consumers have been upgrading their demand for goods and services alongside income growth since the turn of the millennium. For example, total consumer spending on healthcare rose by 5ppt to 11% between 2000 and 2014, but consumer spending on crops dropped by 9ppt to only 5% in the same period (Chart 8).

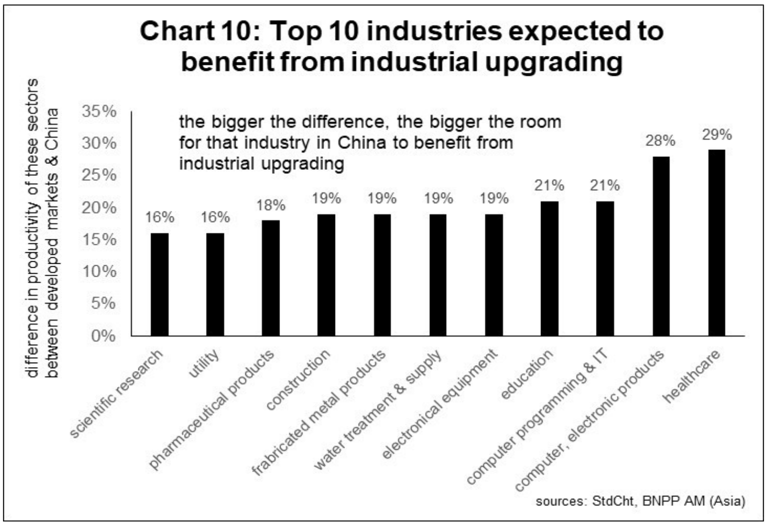


As China moves into a rich country status, its consumption pattern should also converge to that of a developed country. So comparing China's consumption share in various goods and services with those of the developed countries (including the US, the UK, France, Germany, Japan and South Korea in the study here) should give us some clues about those industries that will play catch-up. Basically, the larger the gap the bigger the room for that industry in China to benefit from consumption upgrading (Chart 9).

Meanwhile, those industries that have bigger room to climb the value chain through technological innovation will benefit more from industrial upgrading. Comparing the productivity of Chinese industries with that of the developed countries should give some clues for that assessment. The bigger the productivity difference, the bigger the room for that Chinese industry to gain from industrial upgrading (Chart 10).

[7] See "*China After the Subprime Crisis: Opportunities in the New Economic Landscape*", pp. 129-136
Chi Lo, Palgrave Macmillan, 2010.
[8] "*China – Looking Beyond the 'New Economy'*", Standard Chartered Global Research, 4 December 2018.





THE REAL CHINA GROWTH STORY

The Chinese economy is far from being mature, unlike most players see it. Structural reforms are crucial for pushing China's long-term growth potential beyond the current PPF. Certainly, the day of 10%+ 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.

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