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China's Medium-Term Growth Prospects

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China is in the news every day, either because of its remarkable growth record, or because of immediate concerns about a growth slowdown and the resilience of its financial system. If we look beyond the headlines, and consider China's medium-term prospects, we need to begin by considering China's position with regard to its long-run transformation. The main ideas of this Note can be summarized in three points:

- China is at a turning point that will gradually lead it onto a slower growth path.
- Until quite recently, China had been extraordinarily well positioned to make it smoothly through that turning point.
- Today, due to policy drift and slow response to economic changes, China is in a much less favorable position to make the transition.

Overall, China's long-run position is still quite positive, and we should expect that the country will make a successful structural transformation over the medium term. However, we should also expect some very rocky patches, generating economic turbulence and demanding changes in policy, and greater responsiveness and flexibility. With effective policy making, China should emerge as a successful upper middle-income economic power, but this will not happen without some significant policy adaptation.

The current turning point is in the first instance demographic. The age cohorts entering the labor force from now on are getting smaller, while the age cohort retiring from active labor is beginning a period of rapid growth. At virtually the same historic moment, rural-urban migration has passed its peak, and nearly all the young people in accessible areas have already left the farm. Over the past 20 years, rapid labor force growth in the modern sectors contributed almost two percentage points to annual growth: this contribution will drop to zero in the next 20 years. This type of structural transformation is experienced by every middle-income country. But in China, for essentially accidental reasons—the way that the delayed impact of strict birth control policies coincided with the peak of rural-urban migration—these changes are highly concentrated in the next 5 to 20 years.

The end of China's "surplus labor" is already leading to rapid growth of wages for unskilled workers, and this in turn creates new challenges for China's competitiveness. Rising wages create inflationary pressures which, given China's nearly-fixed exchange rate, are exacerbated by rising global commodity prices. Macroeconomic policy needs

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to adjust to these new conditions. Successful development means creating comparative advantage in a new range of higher skilled sectors, while moving as smoothly as possible out of unskilled, labor-intensive sectors such as garments and toys. Worries about this transition have lead some in China to fret about a possible "middle income trap." How effectively will China navigate through this turning point?

Until very recently, China was extraordinarily well positioned to make this transition. Even a short list of six factors makes this clear. First, rapid expansion of higher education has greatly expanded China's skilled manpower base (annual college and junior college graduates increased from less than a million in 2000 to over 5 million by 2008). Second, China's participation in a broad range of global production chains exposes it to advanced manufacturing techniques and presents opportunities for upgrading beyond the unskilled assembly jobs in which it is currently specialized. Third, China has recently been rising in global research and development networks to become a site for cost-effective research, both basic and applied. Fourth, China's huge domestic market gives it additional flexibility. Fifth, successful 1990s economic reforms have had a tremendous positive, lagged effect on China's growth through the first decade of the 2000s. Finally, China's planners were early to understand the challenges of the turning point, and as early as the 11th Five Year Plan (2005-2010) laid out a program to shift China's economic development strategy towards a less resource-intensive, more knowledge-based, and consumer-friendly growth path.

However, in the last several years, much of this good positioning has been lost. Let me illustrate this point with an anecdote from the coal fields. In 2005 and 2006, the coal-rich province of Shanxi began a program of mine consolidation that involved a substantial measure of privatization. Subsurface coal reserves were sold for an average of around 3 yuan/ton, such that private miners typically invested around 1-200 million yuan in a mine. In turn, this legitimized the position of private mine-owners, some of whom had been mining locally since the 1980s, and attracted a new class of investors (often from the hyper-capitalist merchants of Wenzhou). However, during 2007 a succession of mine disasters and scandals caused the firing of two provincial governors and a dramatic shift in strategy. A new program of renationalization of mines was launched at the end of December 2007 in Linfen County in Shanxi, and by April 2009 a fully operational program of renationalization was in place province-wide. Private miners were compensated for their reserves, at about 1.5 to 2 times their original purchase price. However, the price of coal had increased much more than this since 2005, and miners were not compensated at all for the investments they had made in their mines in the interim. On balance, there was a significant element of expropriation in the renationalization. In 2010, the government announced that re-nationalization would be expanded to other coal-rich provinces, including Henan and Inner Mongolia. Of course, a single anecdote cannot stand in for China's diversity and complexity. However, it can stand as a convenient marker of a broader policy turn, in which I flag four key elements:

1. The end of privatization, and the appearance of episodes of what is arguably expropriation. There are examples of this outside the coal sector, and a lively discussion in Chinese media of *guojin mintui* (the state advancing at the private sector's expense) has emerged. We certainly do not yet see a shrinking private sector or an increase in the

government's ownership share of, say, industry. But China's private businessmen and businesswomen unambiguously face less secure property rights and an increasingly politicized environment. Their investment decisions increasingly must factor in political risk.
2. The economic stimulus policy of 2009 had many positive effects, but also led to a transfer of resources to the state sector, perhaps inevitably. The effect on the financial system has been profound.
3. The policy agenda in place in the early 2000s that envisaged strengthening independent regulatory institutions while opening up more of the economy to fair competition has now clearly stalled out. Sectors from steel to the Internet find that conditions for fair competition have not improved, and both foreign and domestic private firms face increased challenges.
4. The Chinese government has launched a big push in "strategic emerging industries," made up of 35 industrial sectors that correspond to the cutting-edge sectors every (developed) country wants to foster. This is a risky gamble on frontier industries, on leap-frogging into uncharted territory, rather than on catching up by imitating established patterns. It also represents a turning away from cooperation with multinational corporations and inevitably leads multinationals to guard their core technologies more carefully than ever.

Put together, these policy choices have contributed to the failure of the "rebalancing" initiatives laid out back in 2005. With the government trying to maintain rapid growth, the economy has become even more dependent on investment, which has reached unprecedented highs. Exports have again become an important driver of growth in 2011. The cumulative impact of these policy choices can be characterized as follows:

- Rapid growth of infrastructure, but with low utilization.
- Rapid growth of housing, but with low occupancy rates.
- Heavy investment in hi-tech industries, but with as-yet low efficiency.
- Rapid growth in university education, but with many underemployed college graduates.

All these changes are incremental; there is no inevitable cliff to fall off. Economy-wide, rapid absorption of international experience, improved education and skills, and externalities to improve infrastructure all boost productivity. Nevertheless, Chinese government policy is gradually facilitating the accumulation of underutilized resources, and this is likely to begin slowing the pace of productivity growth that has heretofore been outstanding. This trend, as it takes hold, will eventually make the transition to a lower growth rate more difficult to manage.

In a broader sense, the recent policy shift is simply not in the right direction. China needs to increase production and consumption of middle-income goods and services; it needs to tap into native Chinese entrepreneurship in the creation of new products suited to China's large and rapidly diversifying domestic market. It needs more flexibility, more room for initiative, and fewer boundaries on creative behavior. However, policy seems currently to be moving in the opposite direction.

What will happen? For the next year, not much is likely to change. The country is wrapped up in the political transition occurring at every level of the system, from national leaders down to the county level. Given the current policy settings, China's main problems are not going to disappear:

inflation is not going to go away, absent a broader decline in the global economy. However, neither will Chinese demand collapse. Technocrats are focused on problems in the financial system, so they are unlikely to let things unravel by taking their eyes off the ball. The current policy dilemmas will still face the new leadership when it assumes power in October 2012. A year later—say, by October 2013—they will have had a chance to assess the situation, and to acknowledge that current policies simply cannot get China where it needs to go. At that point, significant policy changes are likely, and the implications for China's growth trajectory as well as global growth prospects will be clearer.