China’s High-Income Hopes

http://www.project-syndicate.org/commentary/jun-zhang-explains-what-china-must-do-to-avoid-the-so-called-middle-income-trap

Dr. Zhang Jun is Professor of Economics and Director of the China Center for Economic Studies at Fudan University.

SHANGHAI – It is widely agreed that economic development means more than GDP growth. As China is now learning, one does not guarantee the other. Unless China’s leaders upgrade the country’s growth strategy to stimulate technological progress and structural transformation, high-income status will continue to elude the world’s second-largest economy and most populous country.

To be sure, China’s growth strategy – powered by investment in infrastructure, a massive increase in low-cost manufacturing exports, and technology transfers – has led to some structural change. As labor and capital moved from low-productivity sectors and regions to high-productivity activities, resource allocation became more efficient, real wages rose, and the economic structure was upgraded.

But the growth strategies that lift a poor country to middle-income levels cannot be counted upon to propel it to high-income status. Indeed, there is no shortage of countries whose leaders have failed to recognize their strategies’ constraints and provide enough incentives to encourage the emergence of a new one, causing their economies to stagnate and leaving them stuck in the so-called “middle-income trap.”

Perhaps the most notable exceptions to this rule have been in East Asia, where four economies – South Korea, Taiwan, Hong Kong, and Singapore – responded to external crises and challenges by shifting their growth strategies. For China, whose growth model has so far resembled that used by these economies before they attained middle-income status, a similar shift is urgently needed.

As the late Yale economist Gustav Ranis observed nearly 20 years ago, the key to successful and sustainable development is “avoiding the encrustation of ideas.” For Chinese policymakers, this means recognizing the need to abandon some of the fundamental ideas that underpinned the economy’s past growth, before they become so firmly encrusted that they jeopardize the country’s development prospects.

The first problem is China’s enduring dependence on exports. In the early stages of economic development, almost all growth strategies boil down to trade strategies. But China’s export-led growth model has limits – and the country is reaching them. Unless change comes soon, the foreign-exchange regime and capital controls on which the model relies will become too deeply entrenched, and the window of opportunity for adjustment will be missed.

Another risk is that China's leaders continue to delay efforts to expand the services sector – including finance, insurance, wholesale and retail trade, and logistics – in the hope that the economy can continue to depend on manufacturing. Given how difficult it can be to gain support for such efforts, especially compared to policies aimed at boosting manufacturing, liberalization and expansion of the services sector will require a strong commitment from China's government. Here, Japan's failure in opening up its services sector – which impeded its ability to adapt its economic structure to its declining demographic dividend – can provide much-needed motivation.

The final idea at risk of blocking further progress is that political transformation would undermine social order. One of the East Asian economies' major lessons for developing countries is that economic development leads to institutional transformation, not the other way around.

In Taiwan and South Korea, for example, authoritarian governments after World War II compensated for the weakness of the rule of law by creating transitional institutional arrangements to facilitate GDP growth. In this sense, China has a significant advantage. Countries with weak government capacity have rarely managed to achieve high-income status.

But, as the description of these arrangements as "transitional" suggests, they cannot last indefinitely. After 35 years of dependence on such arrangements, China must embrace the rule of law and establish a reliable, independent judicial system capable of facilitating the liberalization of the services sector, protecting intellectual-property rights, and underpinning a competitive market-based system.

In short, the biggest risk to China's continued development is not a crisis, but the failure of its political leaders and intellectual elites to recognize the need to transform a growth strategy that has proved successful so far. In fact, to the extent that a crisis could do more good than harm, warnings that the rapid credit expansion of recent years could trigger a debt crisis, or that the real-estate sector is on the verge of collapse, may not be as worrying as many believe.

Ideally, no such crisis would be needed. In this scenario, China's economic slowdown since 2008, which could be viewed as China's first modern growth crisis, would be sufficient to force China's leaders to shift their focus from supporting double-digit annual GDP increases to restructuring the economy.

In fact, a consensus already appears to be emerging concerning the need to reduce China's dependence on exports, expand trade in services, attract more foreign investment to its services sector, and accelerate the liberalization of exchange rates, interest rates, and cross-border capital flows – exemplified in the establishment of the Shanghai Pilot Free-Trade Zone last year. And, following the Third Plenum of the Chinese Communist Party's 18th Central Committee last November, China's leaders declared their commitment to allowing the market to play a greater role in shaping economic outcomes.

These are undoubtedly steps in the right direction. The question is whether China's leaders will follow through on their declarations before it is too late.