

## Report

# China's Economic Trajectory: 'Good Enough'

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**Getting the balance right on China [Jason Lee/Reuters]**

### Abstract

China has grown out of isolationist poverty to occupy the center of the world's economy. That growth has brought China's people extraordinary improvements in material well-being, but it is now coming to an end. China's 13th Five-Year Plan (2016-2020) sets out concrete plans to support future growth, but at a very high cost that the Chinese government is already shying away from. The Chinese people have been promised ever higher incomes, but in the end they may have to settle for an economy that is merely 'good enough'.

### Introduction

Once upon a time all roads led to Rome. Now all roads lead to Yiwu, or at least all railroads. Yiwu is a small city (by Chinese standards) of 1.3 million located in the heart of eastern China's Zhejiang province. Yiwu is the eastern terminus of freight rail lines that run as far west as Tehran<sup>(1)</sup> and Madrid.<sup>(2)</sup> It also exports to Germany and other European destinations via intermediate destinations like Chongqing and Wuhan.<sup>(3)</sup> And it's not just railroads that lead to Yiwu. Yiwu is a major focal point for the world's consumer goods supply chains.

How did an obscure Chinese city come to be so central to the world's economy? Yiwu is home to China Commodity City, which is widely regarded as the world's largest wholesale market.<sup>(4)</sup> It is where buyers meet sellers. Very little is made in Yiwu these days -- in the 1980s it became famous as the world capital for the manufacturing of socks -- but everything is sold there. Western journalists are particularly fond of profiling its enormous Christmas market.<sup>(5)</sup>

An industrial park dubbed "Christmas Village" just south of Yiwu is the hub of China's Christmas industry and is reputed to produce some 60% of the world's Christmas decorations.(6) Yet despite this world-beating manufacturing success, workers in Christmas Village earn less than \$1.50 an hour for grueling labor in hot, dangerous factories.(7) That is the Chinese economy in a nutshell: ruthlessly efficient, global in scale, but unable to meet the higher needs of the twenty percent of the world's population that lives there. Workers in China get by, but only just.

Will the future bring better wages and working conditions for the people of China? That depends on one thing more than anything else: GDP growth. Gross domestic product (GDP) is the sum total of the goods and services produced in an economy. China's 2015 GDP of \$11 trillion gave it a GDP per capita of \$7990.(8) Using purchasing power parity (PPP) to adjust for the low cost of living in China, this is roughly the equivalent of \$14,107 in international terms.(9) That is a massive improvement over the mid-twentieth century, but it is still far behind the levels that prevail in developed countries today. China would have to double its GDP just to catch up to Greece, triple it to catch up to Spain, and multiply it by a factor of seven to catch up to the United States.(10) In recent years China has accomplished great things, to be sure, but is it up to the challenge of managing its economy to ensure continued rapid GDP growth?

### **The current state of the Chinese economy**

Understanding growth on such an epic scale as China's requires a shift in mindset. Economists usually understand growth in annual terms: in a good year an economy grows, while in a bad year it stagnates or shrinks. But China's growth since 1978 isn't a product of consistent good economic management keeping the economy moving forward while avoiding bubbles and recessions. China's rapid development is a story of post-communist reintegration and adjustment, not one of compounding annual growth. Despite its extraordinary success, China's GDP per capita is still 44% less than Russia's in PPP terms.(11) If China is to provide a decent standard of living for its people, China's current economy must turn out to be a work in progress, not an end point.

No one would point to Russia as a model of successful post-communist transition. Yet the fact remains that (from a statistical standpoint) Russia's economy delivers substantially greater well-being for its people than does China's. This suggests that, whatever China's trajectory, its economy is still not as efficient or as well-managed as Russia's. In other words, it still has a long way to go. As long as China's economy was growing at more than 10 percent per year, no one much worried about China's economic future: it seemed obvious that China was on an upward trajectory and it was only a matter of time before China blew past the economic accomplishments of Russia, Mexico, Brazil, and a host of other middle-income countries. Now that China's economy is growing at less than 7 percent per year(12), its future seems less clear.

The real question underlying China's economic performance is not "what is China's GDP today?" but "what is China's equilibrium level of GDP?" We all know that China is a transition economy, but no one knows for certain what it is transitioning to. If the answer is "a developed economy like Japan's" then we should expect China to continue its rapid upward trajectory at least until 2040. But if China is transitioning to something more like the major economies of Eastern Europe and Latin America, its transition may be over already.

China's reintegration into the larger global economy since the beginning of its opening and reform period in 1978 has been dramatic. In the early 1980s China's international trade was virtually non-existent, totaling less than 15 percent of GDP, but by 2006 had risen to 65 percent.<sup>(13)</sup> But in retrospect that turns out to have been the high-water mark for Chinese international trade. Trade as a percent of GDP has been declining ever since (to around 40 percent today)<sup>(14)</sup> and in 2015 China's levels of international trade actually fell in absolute terms.<sup>(15)</sup> Foreign direct investment tells a similar story, having reached a maximum of nearly 5 percent of GDP in 2006 before falling to less than 3 percent today<sup>(16)</sup> -- much of it Chinese money that is merely round-tripped through offshore accounts. There are good reasons to believe that China's reintegration into the global economy is now complete.

The signs that China would converge toward middle-income rather than high-income levels of GDP per capita were already visible five years ago: a declining working-age population, endemic corruption, catastrophic levels of environmental degradation, and generally poor economic governance.<sup>(17)</sup> They are even clearer today. Though China's officially reported rate of economic growth in 2015 was 6.9 percent<sup>(18)</sup>, the reality is that nearly all of China's current GDP growth is derived directly from government deficit spending.<sup>(19)</sup> Money is sluicing out of the country at a rapid rate<sup>(20)</sup>, fueling real estate booms in cities as disparate as London, Sydney, and Vancouver.<sup>(21)</sup> Whatever story China may seek to tell the world about the current state of its economy, those who should know best don't seem to buy it. China is slowing, and China's new rich (just like Russia's new rich a decade earlier) are rushing for the exits.

### **China's 13th five-year plan**

China does have a plan to revitalize its economy and restart failing economic growth: the 13th Five Year Plan.<sup>(22)</sup> The success of this comprehensive economic and social plan covering the years 2016-2020 is crucial if China is going to avoid stagnating at middle-income levels of development. And credit where credit is due: it's a great plan. China plans to double average incomes from 2010 levels, increase life expectancy by one year, bring social insurance coverage rates up to 100 percent, build 50 new airports, expand high speed rail, reduce air pollution by 25 percent, end rural poverty, connect 98 percent

of villages to high-speed internet, and create 50 million new urban jobs.(23) There is a drumbeat of attention to employment: both President Xi Jinping(24) and Premier Li Keqiang(25) have given major speeches stressing the need for higher levels of employment, especially for new university graduates.

An exciting and provocative (though admittedly highly authoritarian) idea embedded in the 13th Five Year Plan is a proposal to lift 10 million people out of poverty by simply closing down their villages and moving them to more urban areas.(26) Families will be incentivized to move through government relocation subsidies that will pay for urban housing. At the macro level this makes a lot of sense: many small, remote rural communities are not economically viable in the twenty-first century. That said, the opportunities for bullying and corruption in such a program seem rife. And it is not clear just what these former farm-dwellers will be expected to do for a living in their new urban homes.

More encouraging is the proposal to connect every remaining rural village to the country's expanding transportation network. This initiative calls for the construction of 500,000 kilometers of paved roads in rural areas.(27) In villages themselves streets will be paved with asphalt or concrete -- another 150,000 kilometers of road surface.(28) If China really does succeed in connecting every rural village with paved roads and high-speed internet it will be an incredible accomplishment indeed. These programs will go a long way toward helping China raise rural incomes, since they mean that China's rural villages will no longer really be 'rural' in the economic sense. They may remain pastoral, but they will no longer be isolated. A well-connected rural population stands every chance of economic success -- and if they are not successful, their newfound connectivity will facilitate their migration to cities where greater opportunities await.

As promising as China's new Five Year Plan looks on paper, China will face serious challenges in implementing it in practice. The number one challenge will be paying for it. China's government budget deficit is rapidly expanding, from an acknowledged 2.3 percent of GDP in 2015(29) to a mooted deficit of 'over 4 percent' in 2016.(30) China's real budget deficit may in fact be much higher, high enough to put its Five Year Plan spending proposals at risk.(31) And in early May, 2016 the official People's Daily newspaper raised a trial balloon suggesting that China may have to cut spending after all. The paper conducted an interview with an anonymous 'authoritative person' (code word for a senior party official) who suggested that China may enter a long-lasting period of slow growth during which it would be impossible to continue high levels of deficit spending.(32) Only a few months after embarking on an admirably ambitious Five-Year Plan to launch the Chinese economy into the twenty-first century, China is already dialing back expectations for the fulfilment of its promises.

## Implications for the Middle East and the world

For good and for bad, China's economy isn't going anywhere. Trains full of Christmas decorations will continue to roll out of Yiwu bound for Europe, and for what it's worth more and more Chinese Nowruz decorations are likely to show up on store shelves every March in Iran. China is firmly planted at the center of global manufacturing supply chains, and there it will stay. Stalling growth does not imply a collapse. It does, however, imply economic stability -- and from the perspective of the last four decades, economic stability is itself a radical departure for China. Companies that came to expect endless and effortless double-digit sales growth in China will now have to come to terms with a new reality. The China of the future will still be a big market, even a huge market, but not an expanding market. With slow growth in GDP per capita and a soon-to-be-declining population, by 2020 the Chinese market may even be shrinking.

Commodities exporters of all kinds will feel the pinch first -- and that includes oil. Many already have. For other exporters to China the pinch is coming soon. The IMF expects Chinese goods imports to expand by less than 1 percent per year in 2016 and 2017 and over the long term to stabilize at an annual growth rate of just 2.5 percent.<sup>(33)</sup> That's a far cry from the old increases of more than 20 percent a year, and the IMF's projections themselves may be overly optimistic. The luxury goods market in China has already collapsed.<sup>(34)</sup> Pundits routinely attribute that to President Xi Jinping's aggressive anti-corruption campaign, but the end of China's economic boom has dramatically reduced the scope for big winnings in the Chinese economy.

Another constituency that will feel the pinch are the neighboring countries that have signed up for China's 'One Belt, One Road' (1B1R) initiative. Many countries that have received promises of Chinese aid under 1B1R may be sorely disappointed. Since the turn of the twenty-first century China has been dripping in easy money. Just as Chinese consumers turned to buying extravagant luxury goods, the Chinese state turned to funding extravagant development projects throughout the Middle East, Africa, and beyond. Now that the money is drying up, expect the Chinese state to follow Chinese consumers into retrenchment. When the Chinese government had money to burn, budgets were unconstrained. But when the Chinese government has to choose between building roads in rural Pakistan and building roads in rural China, it is hard to imagine that this ambitious but cautious country will choose the former. Expect many such promises to go unfulfilled.

For thirty-eight years since 1978 China's economic trajectory has pointed in one direction: up. The Chinese economy grew into the second-largest in the world, and paltry local markets like those in Yiwu grew with it to become important nodes of the global economy. But China didn't just grow. It integrated. Now that China has found its place at the heart of the global economy, that integration has run its course and

China's growth has stalled. China is now the most important middle-income country in the world. Given that India is geographically much more poorly positioned for global integration, China is likely to remain the world's most important middle-income country for the indefinite future. But it will remain a middle-income country. For its strategic competitors that will come as a relief; for its suppliers a minor tragedy. But for the people of China, it may be simply 'good enough'.

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