An Overview of
“A New Economic Growth Engine for China: Escaping the Middle Income Trap by NOT Doing More of the Same”

Wing Thye Woo (胡永泰)
Fudan University, Shanghai
Columbia University, New York City
Brookings Institution, Washington D.C.
Penang Institute, George Town
University of California, Davis
Central University of Finance and Economics, Beijing
wtwoo@ucdavis.edu

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Historical Perspective and Definition

• In 2012, China has been the fastest growing country in the world for 35 years.
• In 1912, what is the country that had been the fastest growing country in the world for the last 35 years? What is its position today?
• When do we know that a country is caught in the middle-income trap? *The country shows no tendency to converge to the living standard of the global economic leader, e.g. it stays at 50% of the living standard of the global leader for 20 years or more!*

Catch-Up Index (CUI)

• CUI = country’s income level / US income level
• boundaries of income group is based on notion that most of Western Europe is high-income and most of sub-Saharan Africa is low-income,
  – CUI >55% for high-income,
  – CUI<20% for low income
• 1960: 20 countries high, 32 middle, 80 low
• 2008: 27 countries high, 24 middle, 81 low
• *China entered middle-income in 2006*
Club Convergence in Largest Economies in Western Europe (High-Income Club) and in South America (Middle-Income Club)

Western Europe: Maintain 70%
GDP per capita (PPP) of Western Europe as % of US Level

France - Germany - Italy - Sweden - UK
Latin America: Stuck at 30%

GDP per capita (PPP) of Latin America as % of US Level

Is Divergence the Norm in the Largest East Asian Economies? Go Malaysia!
Developing Asia: Moving Along, Now 20%, Malaysia and Thailand are the best performers

GDP per capita (PPP) of Asia-6 as % of US Level

“High-Performers” Malaysia was richer than South Korea and Taiwan in 1965 – wallowing in middle-income trap since 1996. China to become 2nd Malaysia?

Japan, S. Korea, Taiwan and Malaysia: Living Standard as % of USA Living Standard
3 of the messages in the book:

• Catch-up momentum is difficult to maintain because just doing more of the same does not work e.g. Soviet catch-up via heightened investment

• Stage-specific obstacles to moving up e.g. during earliest catch-up stage, economic reforms much more important than socio-political reform

• Domestic policy must be in line with international economic environment; and must change along with it

China as a Speeding Car: Types of Potential Crashes

• Hardware failure (wheel comes off): failure in economic mechanism, e.g. banking sector collapse, fiscal mismanagement

• Software failure (a fight inside the car): failure in governance, e.g. corruption, incompetence

• Power supply failure (run out of gas or hit a road block): failure in environmental management or failure in managing foreign economic relations, e.g. water shortage, trade sanctions

• Interpreting Hexie Shehui software failure is the most probable
Relationship among the 3 types of failures: The Anna Karenina Principle

- Leo Tolstoy in opening of *Anna Karenina*: “Happy families are all alike; every unhappy family is unhappy in its own way.”

- Which is the correct translation of Tolstoy?
  a. $Y = X_0 + aX_1 + bX_2 + cX_3$
  b. $Y = X_0 X_1^d X_2^e X_3^f$

  where $Y$ = level of happiness,
  $X_i = 0$ $\Rightarrow$ Failure $i$ has occurred
  $X_i > 0$ $\Rightarrow$ Degree to which Failure $i$ is being successfully addressed

- Needs whole package to work, needs the whole package to work. Existence of prerequisites, no substitutability

A Policy Exhuastion Scenario:

$Y = X_0 - a/X_1 - b/X_2 - c/X_3 + (X_1^d X_2^e X_3^f)$

$Y = 10 - 1/x$
China should adopt a new paradigm in:

- **Yuan Zhigang on demand-management** e.g. no 2008 style macro-stimulus for the 2012 slowdown
- **Chen Zhao and Lu Ming on urbanization strategy** e.g. reduce discrimination against the largest cities like Shanghai & Tianjin
- **Feng Jin and He Lixin on pension system** e.g. build a sustainable financing mechanism
- **Zhang Yan on fiscal system** e.g. an efficient central-local fiscal arrangement
- **Zhang Liqing on financial sector** e.g. small-medium private banks
- **Klaus Lackner, Sarah Brennan, Cai Ximing and Upmanu Lall on energy and water management** e.g. international coordination and virtual water flow

Needed to prevent Software Failure: Improvement in Socio-Political Governance
Trickling Down is now weaker, Extreme Poverty is Entrenched

Proportion of Rural Population Below Poverty Line (%)
The poverty line is measured in 1985 PPP US$.

Income Distribution Worse than the Already Bad Picture from govt data

<table>
<thead>
<tr>
<th>Category</th>
<th>% of urban residents</th>
<th>Official income (RMB)</th>
<th>&quot;True&quot; income (RMB)</th>
<th>Distribution of hidden income (%)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Lowest income</td>
<td>10</td>
<td>4,754</td>
<td>5,350</td>
<td>0.4</td>
</tr>
<tr>
<td>Low income</td>
<td>10</td>
<td>7,363</td>
<td>7,430</td>
<td>0.0</td>
</tr>
<tr>
<td>Lower middle income</td>
<td>20</td>
<td>10,196</td>
<td>11,970</td>
<td>2.3</td>
</tr>
<tr>
<td>Middle income</td>
<td>20</td>
<td>13,984</td>
<td>17,900</td>
<td>5.1</td>
</tr>
<tr>
<td>Upper middle income</td>
<td>20</td>
<td>19,254</td>
<td>27,560</td>
<td>10.9</td>
</tr>
<tr>
<td>High income</td>
<td>10</td>
<td>26,250</td>
<td>54,900</td>
<td>18.8</td>
</tr>
<tr>
<td>Highest income</td>
<td>10</td>
<td>43,614</td>
<td>139,000</td>
<td>62.5</td>
</tr>
<tr>
<td>All urban dwellers</td>
<td>100</td>
<td>16,885</td>
<td>32,154</td>
<td>100.0</td>
</tr>
</tbody>
</table>
A New Vision Unveiled in 2006

- October 2006, new CPC objective was to build a harmonious society, *hexie shehui*, defined as
  - a democratic society under the rule of law
  - a society based on equality and justice
  - an honest and caring society; and
  - a stable, vigorous and orderly society
  - a society in which humans live in harmony with nature
- **Problem identified**: China is not heading toward a harmonious society
- **Solution**: Adopt *kexue fazhan guan* to increase accountability of the state to induce better performance

Needed to Prevent Power Supply Failure: A New Approach to External Trade and Diplomatic Relations
Harmonious Foreign Relation

- Because domestic Chinese economic development has large impact on other major countries, it is not possible for China to build a harmonious society without also having to help build a harmonious world.

Problem: China has a “harmonious society” mindset but not a “harmonious world” framework. China reacts and does not take initiatives to provide global public goods.

Solution: Internationalise Hexie Shehui (Harmonious Society) Principle to have parallel Hexie Shijie (Harmonious World) Principle, e.g. take leadership role in pushing
- Doha Round forward
- Global Accord on Climate Change

References

- Woo, Wing Thye (2008), 'Understanding the Sources of Friction in U.S.-China Trade Relations: The Exchange Rate Debate Diverts Attention Away from Optimum Adjustment,' Asian Economic Papers, Vol.7(3), pp.61-95