A New Normal, but with Robust Growth: China's Growth Prospects in the Next 10 Years

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The Chinese Economy is Rebalancing

There are strong signs that the Chinese economy is entering a stage of a "new normal." Since the global financial crisis hit in 2008, China's growth rates have declined from double-digits to around 7.5 percent per annum. The economy is rebalancing: Export growth has substantially slowed down, from an average of 29 percent per annum between 2001 and 2008 to under 10 percent per annum in recent years. As a result, exports have become less important for the country's growth, to the point that the contribution of net exports has become negligible, if not negative, while the indirect contribution of exports through forward and backward linkages has also shrunk. Consequently, the overall contribution of exports to growth has declined from 3 percentage points to about 1 percentage point. Both employment and output of the manufacturing sector as a share of the national total began to decline in 2013, with manufacturing output was smaller than service output for the first time. In the first half of 2014, services accounted for more than half of the country's growth. It seems that China has passed the turning point of the inverse U curve of manufacturing widely observed for advanced countries in their earlier days (e.g., United States in the late 1950s, Japan in the early 1970s). In accordance, domestic consumption as a share of GDP stabilized in 2008 and finally began to rise in 2013. The size of China's current account surplus has shrunk quickly, accounting for about 2 percent of GDP in recent years.[1]

Rebalancing has helped China to improve its income distribution. Growth slowdown is uneven across the country; it mostly happens in the coastal provinces that produce more than 85 percent of China's exports. Inland provinces have kept relatively high growth rates, creating convergence within the country. As a result, the national Gini coefficient of personal income declined from 0.481 in 2010 to 0.473 in 2013 (see Figure 2).

This transformation has been brought about by three forces. The first is the global adjustment following the 2008 financial crisis. Using other East Asian economies as a reference, China would probably have had to wait until 2015-2018 to pass the peak of the inverse U-curve of the manufacturing sector. The slowdown of world demand has accelerated the adjustment of the Chinese manufacturing sector.

The second is China's demographic transition. This transition is comprised of two parts. One is the change of age structure of the whole population. The country's working-age ratio (i.e., the number of people between 16 and 65 years old divided by the number of people younger than 16 or older than 65) reached its peak of 2.6 in 2010 and has since begun to decline. In fact, the absolute number of working-age population began to decline in 2012. The second transition is the movement of the labor force from the countryside to cities. The rapid economic expansion in the period 2001-2008 brought about 200 million people out of agriculture. Although the countryside still retains 35 percent of China's total labor force, grossly under-matched by agriculture's share of national GDP (barely 10 percent), the rate of migration has slowed substantially. Considering these two transitions, it is understandable why its economy has begun to slow down since 2010.

The third force is the slowdown in investment growth. The Chinese economy relies heavily on investment for growth. To deal with the negative impact of the global financial crisis, China launched a major investment drive in the second half of 2008 and 2009. However, the growth of investment has since slowed. It is noteworthy that infrastructure and housing each account for one third of China's total investment. The slowdown in investment has been largely caused by a slowdown in those two sectors.

Reasonable Growth Rates in the Next Decade

The new normal implies lower growth rates for the Chinese economy. But how low? Some prominent economists in China, such as Cai Fang, believe that China's new normal will entail growth rates in the range of 6 percent to 7 percent or even lower in the next 10 years.[2] Estimates provided by international organizations arrive at similar numbers.[3] This prediction is mostly driven by the negative demographic trend that began in 2010. However, the negative impact of this negative trend may be overestimated.

First, extrapolating China's past growth records to predict its future growth rates is problematic when there exists a reversal of trends in some determining variables, such as the working-age ratio. Because China's growth was so extraordinary before the global financial crisis, the marginal rate of contribution of an increasing working-age ratio could be overestimated in the conventional regression analysis. When this rate is applied to a declining working-age ratio, the negative impact of the ratio is also overestimated.

Second, although the speed of rural-urban migration has declined, there is still labor redundancy in the countryside. Agriculture only accounts for 10 percent of China's GDP, but 35 percent of the country's labor force are still in the countryside.

Third, China will enjoy large educational dividends created by cross-generational substitution in the next 20 years. The rate of return-adjusted educational attainment of the retiring cohort (i.e., 50-60-year-olds) is only half of that attained by the newly employed (i.e., 20-25-year-olds).[4] That is, new workers are twice as productive as retir-ing workers. Educational attainment of the youth is improving steadily. Currently, 27 percent of 18-22-year-olds have a college education; by 2020, that number will reach 40 percent. This swift improvement of human capital among young people has offset part of the net loss of labor.

Fourth, China's retirement ages are very low by any standard. Currently, female workers can retire at the age of 50, and male workers can retire at the age of 55. The labor force participation rate is barely above 60 percent in the whole population. By the age of 52, half of women are not working; by the age of 58, half of men are not working. It is widely accepted in China that the current retirement ages should be raised. Even if the retirement age were to be raised by half a year each year in the next 10 years, the reduction in the working-age population, now standing at 2.5 million a year, would be more than compensated.

Setting aside demographics, other factors remain favorable to China. Investment as a share of GDP is likely to decline, but it will probably take a decade for it to drop below 40 percent, during which time the stock of capital can still maintain a reasonable growth rate. On top of that, China's innovation capacity is being strengthened. In addition to improvements in human capital, China's spending on research and development (R&D) is accelerating. By 2015, R&D spending will reach 2.2 percent of GDP, moving close to the ratios prevailing in advanced economies.

With those considerations in mind, it is a useful exercise to use the international experience to predict China's future growth. Toward that goal, we collected data on 106 countries for the period 1985-2011, mainly from the World Bank Development Index (WDI) dataset, and ran the conventional growth regression on the growth rate of per capita GDP.[5] As growth determinants, we considered per capita capital stock, the working-age ratio, infant mortality rate, college enrollment rate, and research productivity (defined as papers published per researcher). The first two variables measure

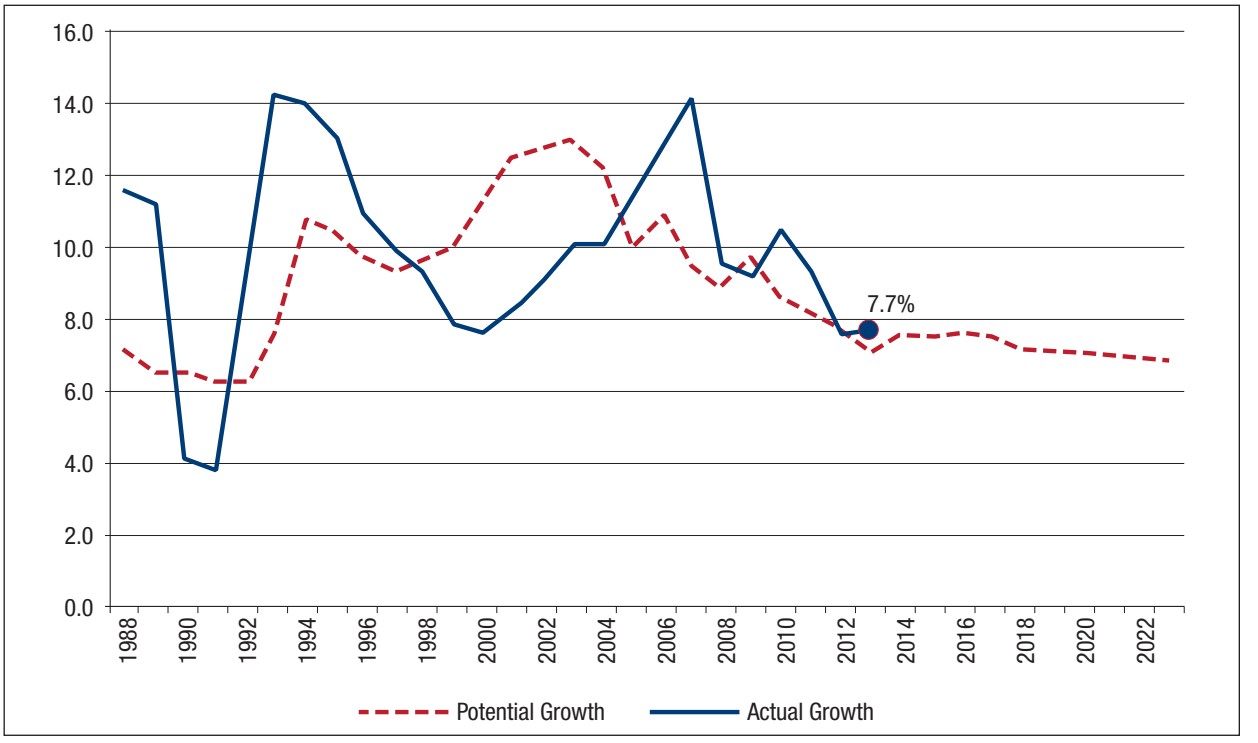
the two most important inputs, capital and labor, and the last three variables control a country's health and human capital as well as research capability. With the regression results, we can calculate China's potential growth rates in the data period. Assuming that the growth determinants other than the working-age ratio grow by their averages in the sample period, and the working-age ratio declines by an accelerated pace of 0.4 percent, 0.5 percent, and 0.6 percent, starting in 2014, and also assuming that the global growth trend keeps its average of the sample period (i.e., 3.8 percent), we then predicted China's potential growth rates for the period 2014-2023. Figure 1 presents the historical and future potential growth rates (converted into GDP growth). As a comparison, the actual GDP growth rates are also presented.

The comparison between the potential rates and the actual rates matches China's business cycles. The Chinese economy outperformed its potential growth rates in two periods, the 1990s before the Asian financial crisis and the years around the global financial crisis. In between, the Chinese economy experienced deflation and its actual growth rates were below its potential growth rates. China's potential growth rates in the next 10 years are predicted to be in the range of 6.9 to 7.6 percent, with an average of 7.27 percent. This is indeed much lower than the 9.4 percent average in the period 1988-2013. Because the growth determinants other than the working-age ratio are assumed to keep their historical trends, this decline is mainly driven by China's worsening demographics. It is worth mentioning, though, the prediction assumes that China's labor participation rate remains constant. As indicated previously, the unfavorable demographic trend can be neutralized if China gradually raises the retirement age.

A Note on the Piketty Thesis

Based on a large quantity of historical data, Thomas Piketty (2014) proposes that income distribution in a capitalist system will inevitably be worsened because the share of return to capital in national income increases steadily. The key premise is that the rate of return to capital—the interest rate—is higher than the growth rate of national income. Piketty believes that this premise holds in

FIGURE 1. CHINA'S POTENTIAL GROWTH RATES (PERCENT)



Source: Author's own calculations.

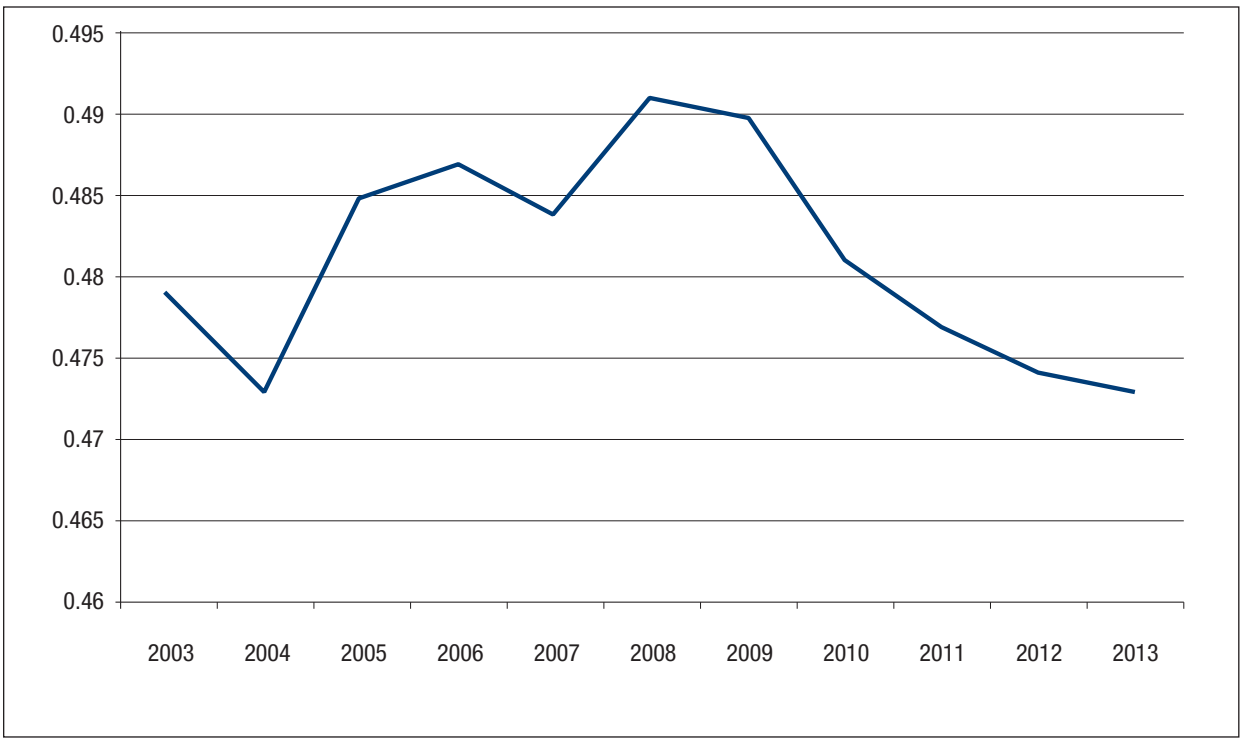
slow-growing countries. However, it also applies to China, a fast-growing country. Although the baseline interest rate is relatively low, often around 6 percent, the interest rates prevailing in the shadow banking sector and informal markets, now growing quickly, is often higher than 10 percent. However, Figure 2 shows that China seems not to have followed Piketty's thesis; instead, the Kuznets Curve seems to have prevailed in recent years. The official data may report lower Gini coefficients because the National Bureau of Statistics (NBS) household surveys are likely to miss the very poor and the very rich, but the declining trend since 2010 is confirmed by other independent surveys. For example, data from the China Family Panel Studies (CFPS), a national representative longitudinal survey carried out by Peking University every other year since 2010, show that the income Gini coefficient declined from 0.52 in 2010 to 0.50 in 2012.

The decline in inequality has happened not just at the aggregate level; the share of the very rich has also declined. According to the CFPS data, the share of income of the top 10 percent declined from 38.2 percent in 2010 to 35.3 percent in 2012, and the share of the top 1 percent declined from 10.9 percent to 9.5 percent in the same period.

China's income distribution continued to worsen throughout the reform period following 1978. It is probably not incidental that this trend began to be reversed in 2008. The slowdown of the world economy hit China's coastal provinces more than its inland provinces. In addition, wage growth in the coastal provinced forces many companies to move inland. As result, a strong trend of convergence has happened among Chinese provinces and cost-adjusted wages are converging across the country. Labor share in the national income declined steadily beginning in the mid-1990s and hitting a low of 40 percent in 2008. However, it has since begun to rise, climbing above 45 percent in the last two years. There is no doubt that wage growth has contributed to this reversal. However, the effect of structural change cannot be underestimated either.

In developing countries, manufacturing is typically the most capital-intensive sector and thus its

FIGURE 2. CHINA'S INCOME GINI COEFFICIENTS



Source: National Bureau of Statistics, January 20, 2014, at www.stat.gov.cn.

labor share is the lowest among the major sectors. As a result, the labor share in the whole economy declines when a country's manufacturing sector expands. This is what happened in China before 2008. The global financial crisis accelerated China's structural change. The manufacturing sector reached its peak, and its share has begun to decline. This trend will likely be sustained if the world economy does not experience a boom similar to the one that occurred in the pre-crisis period. The Chinese economy will move toward a more service-based economy, and the labor share in national income will continue to rise.

The advanced economies may be a different story, though. The economic structure is quite stable in most of them. The dominance of the financial sector and the hollowing-out of industry are likely to be the main culprit in worsening income distribution. However, this does not mean that structural change is impossible in those economies. With certain supporting government policies, re-industrialization is not impossible.

Global Implications

Can China serve as a reasonable predictor for other developing countries? The answer is uncertain. It all depends on the specific circumstances in each country. The economies that have successfully upgraded their income levels shared strong commonalties: high saving rates, high investment rates, high working-age ratios, healthy populations, manufacturing-dominated exports, long-lasting periods of industrialization and stable political environments. China shares each of these commonalties, but other developing countries do not. Judging by their slow growth in recent years, rapid growth in emerging economies, excluding China, and some developing countries before the financial crisis was likely a consequence of their riding the tide of world growth. The world economy is entering a stage of mutual enhancement, that is, a country's growth depends highly on other countries' growth. This has a lot to do with the fragmentation of production. The production process of a consumer product is often sliced into dozens of sub-processes that are scattered across many countries. This renders it obsolete to identify where a product is produced. "Made in China" is really made all over the world. One of the consequences is the separation of production and consumption, which is more pronounced in advanced economies that increasingly specialize in producing high value-added intermediate goods. As a result, those economies import large quantities of final products, and thus they become the last resort of consumption. The global financial crisis has substantially weakened the demand from advanced economies so, in turn, the growth of the rest of the world has slowed. The impact of a weakened U.S. economy is particularly detrimental. Since 2008, the U.S. economy has on average grown 1.6 percent less than in the period 2001-2007 (from an average of 2.5 percent to an average of 0.9 percent). Cross-country CGE (computational General Equilibrium) models show that this has caused an average drop of 0.32 percentage points for the annual growth in other major economies.[6] If the U.S. economy can reach the goal set in 2014 by G-20 finance ministers of an additional 2 percentage points of growth in the next five years, other major economies will benefit by 0.4 percentage points.

Robust growth in China can compensate for some of the losses left by advanced economies if these economies can only achieve mediocre growth in the future. China's share of world nominal GDP is already 12 percent. It will probably increase to 20 percent by 2023. Being the world's factory, China creates demand for surrounding Asian economies and other resource-exporting economies that export either intermediate goods or resources to the country. However, China's contribution will be modest in the near future. Cross-country CGE models show that China's current growth spillover to the rest of the world is barely above one tenth of the U.S. level. The world may have to wait until China enjoys much higher per capita income to expect the country to become a major consumer goods importer.

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Endnotes

1. Data on China are from the National Bureau of Statistics (NBS at www.stat.gov.cn) if not otherwise specified.
2. Cai (2014)
3. E.g. Rodlauer (2014)
4. Cui and Yao (2014)
5. Chen and Yao(2014)
6. CCER Macroeconomics and Growth Team (2014)