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The turning point in China's economic development

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'All roads lead to Rome', they said, two thousand years ago on the Western peninsular of the Eurasian continent. Or, at the Eastern end, 'All roads lead to Changan'.

This year in China, all roads lead to the turning point in economic development.

There is now a persistent tendency for growth to exceed the 7.2 per cent per annum that would realise the authorities' ambitions to quadruple turn of the century output by 2020; for labour to become scarce and more expensive in rural and urban areas; and for surpluses in external payments to argue for exchange rate appreciation. There is rapid progression towards the point where the number of workers falls, especially of younger unskilled workers who have driven the rapid growth of industrial China over the past one and a half decades. Focus on the labour market identifies the importance of breaking down barriers to rural-urban migration and other inhibitions against employing increasingly scarce and valuable human resources in their most productive uses. Analysis of the rural economy notes that China has become a net importer of agricultural products, reflecting the change in comparative advantage that accompanies sustained rapid economic growth. A look at the natural resource based industries discovers that urbanisation, and the shift towards more capital-intensive industrial structure, has made Chinese economic growth the source of profound change in the global balance of supply and demand for minerals and energy. Contemporary global environmental problems are inextricably linked to Chinese growth and structural change. And environmental concerns are beginning to influence policy and resource allocation, as they have in other countries as incomes have risen in the process of economic growth, but at lower measured incomes than in other economies.

The theme of this year's review of recent developments in and research on the Chinese economy selects itself. China has or is fast approaching reached the turning point in its economic development, at which 'surplus' labour from agricultural employment in the countryside ceases to be available to drive the growth of the modern economy; so that labour becomes scarce and valuable; forcing large real wage increases and real exchange rate appreciation; which generate structural change towards more capital-intensive and technologically sophisticated industrial structure at the relative expense of labour-intensive manufacturing and agriculture; and changes fundamentally the character of China's interaction with the international economy.

Thirty years ago, Ryoshin Minami published an important book on postwar Japanese economic development, *The Turning Point in Economic Development: Japan's Experience* (1973). Minami applied to the Japanese case the theory of the turning point formulated by Lewis (1954), and elaborated in an East Asian context by Fei and Ranis (1961, 1963, 1964a, 1964b, 1966).

In the Lewis model of economic development, rapid economic growth in its early stages is driven by the presence of 'surplus' labour in the traditional, rural economy, and its movement into more productive modern employment in urban areas. The apparently infinitely elastic supply of unskilled labour from the countryside allows rapid modern sector growth to proceed for a considerable while without putting upward pressure on wages. Over time, the withdrawal of 'surplus' labour from agriculture increases per capita land and other resource endowments enough to raise the marginal productivity of labour and therefore of incomes and wages in the rural sector. The labour supply from rural areas to the modern economy becomes inelastic: higher wages must be offered to induce additional movements of labour into the rapidly growing modern economy. From this point, wages in both rural and urban areas rise more rapidly the faster the rate of economic growth.

The 'turning point in economic development' is the point at which surplus labour in the countryside dries up, and real wages begin to rise. Other major economic changes occur around this point. Demand for agricultural products grows more rapidly than supply, and there is a tendency for net imports of agricultural products to rise. Industrial structure becomes more capital-intensive, having implications for demand and net imports of minerals and energy. The prospects for continued rapid growth beyond the turning point depend on the economy's success in structural change towards industries which can expand profitably despite higher labour costs. This places a premium on flexibility in the allocation of capital and labour resources, on the efficiency of financial markets in allocating scarce capital to its most productive uses, and on education and the accumulation of labour skills.

One feature of the turning point is that the higher wages complicate non-inflationary management of monetary policy. Wages must rise by one process or another, in terms of both domestic and international purchasing power. The adjustment can occur in a non-inflationary way through appreciation of the exchange rate. Or the adjustment can be achieved through monetary accommodation of the pressures for increased wages, with high and potentially destabilising inflation, but without the inflation being accompanied by correspondingly large currency depreciation. The real exchange rate appreciation, whether achieved through nominal exchange rate appreciation or inflation, moderates what would otherwise have been a powerful tendency towards external trade and current payments surpluses.

Real exchange rate appreciation at the turning point makes standard technology, labour-intensive exports less competitive. These industries were the mainstays of internationally oriented growth in its early stages. This can appear to be a threat to the continuation of rapid growth. In reality, it is resistance to structural change that is the threat to growth.

There is some risk that the Chinese authorities are misjudging the nature and consequences of current internal pressures for structural change. They are seeking to reduce the rate of economic growth below the rates in excess of 10 per cent towards which they have been tending. The attempts at reduction in the rate of growth have been motivated by concern for the emergence of inflation. The preferred instruments have been direct controls and tightening of access to credit, aimed at reducing the level of investment. To the extent that these measures are successful, they will reduce the growth in domestic demand further below the economy's growth in productive capacity and increase the external payments surplus. The surplus is already huge and growing at an extraordinary rate. It is already the source of considerable tension in China's foreign economic relations, especially with the United States. And it will, sooner or later, become a source of unwanted and destabilising monetary expansion and inflation.

Whether the upward adjustment of real wages is secured through inflation or exchange rate adjustment, it will lead to measured income and output 'catching up' with other countries more quickly than a simple comparison of growth rates would suggest (Garnaut 2002:9–13). Thus, at the point at which labour became scarce and wages began to rise rapidly, each of the East Asian economies that had secured successful economic development before China experienced rapid movement towards the average incomes and output, conventionally measured, of the developed countries. For example, at the extremes of rapid catching up, Hong Kong per capita incomes expressed in US dollars doubled between 1971 and 1973. Korean per capita incomes expressed in US dollars roughly doubled in three years from the mid 1970s. Singapore per capita incomes expressed in US dollars increased by about three quarters between 1971 and 1974 (Garnaut 2002:10).

The 'turning point' will not be as sharp in China as it was in Japan, Hong Kong, Singapore, Taiwan and Korea. Greater size and geographic and economic diversity, and more daunting internal barriers to the movement of people, goods, services and capital, mean that labour scarcity will spread more slowly from the main centres of economic dynamism in China. The upward adjustment in the real exchange rate will occur over a decade or two, rather than a few years.

Nevertheless, the adjustment will be fast enough significantly to affect China's place in the global economy and society over the next two decades. Justin Yifu Lin (Chapter 4), shows that the Chinese official goal of quadrupling output over the next two decades—implying compound growth at 7.2 per cent per annum—is achievable, so long as some important structural weaknesses are corrected If the weaknesses are removed, the official target might be exceeded by a significant margin. The most important barriers to continued strong growth are associated with weaknesses in financial institutions, and in the continuation of economically inefficient state-owned enterprises in major roles. Thus reforms of the financial sector and of state-owned enterprises will be major determinants of future economic success.

Xiaolu Wang (Chapter 3) demonstrates that, following the large, upward adjustments in official figures late in 2005, China's national accounts data converted at current exchange rates, measure GDP at 18 per cent and per capita output at 4.1 per cent of United States levels. The Purchasing Power Parity (PPP) data measure GDP at 69 per cent and per capita GDP at 17.6 per cent of United States' levels. Wang's careful analysis of the corrections to the national accounts in late 2005 raises questions about whether the December 2005 revisions of the national accounts are the last such changes. It is likely that the present starting point for estimating the future size of the Chinese economy may turn out to be higher than the current official data suggests.

The rapid increase in the real exchange rate that follows the turning point in economic development leads to convergence over time in national accounts and PPP measures of output. The accelerated 'catching up' that was observed in Japan, Korea and other successful East Asian economies beyond the turning point, for this reason, is apparent in the conventional national accounts and not the PPP measures of output. The PPP data is therefore the appropriate base for comparison when differential growth rates are applied to the estimation of how long it will take a developing country to catch up with an economy at the frontiers of global productivity and incomes.

It is well within the bounds of possibility—in the absence of domestic or international political instability seriously disrupting the process of economic reform and growth—it is likely that average growth rates will turn out to be significantly higher than the official objective for much of the next two decades.

Chinese wages and consumption could be expected to grow substantially more rapidly than per capita output.

The following chapters, embodying the results of some of the best recent research on the Chinese economy, by analysts based in Australia, China and the United States, provide important background to the generalisations that I have presented in this introductory chapter.

Ross Garnaut and Yiping Huang (Chapter 2) examine recent macroeconomic performance in the context of the theory of the turning point in economic development. The past year has been good for Chinese growth by the conventional measures of performance. Growth has risen above 10 per cent, the highest for about a decade, while maintaining low inflation. Growth continues to be unusually dependent on investment. There is less anxiety now than a year ago that the high investment rates will be a source of vulnerability in the near term—although a fear that excessive investment levels will be inflationary and destabilising continues to haunt the policy community. There is, however, recognition that, sooner rather than later, consumption must come to carry a much heavier load in supporting domestic demand growth.

Savings continue to rise from extraordinarily high levels. Thus even unprecedentedly high and rising investment rates leaves savings well in excess of investment. The consequence is a huge and rising trade surplus. Imports are growing rapidly—at a faster rate than in any other substantial economy—but exports are expanding faster still. The current account surplus is augmented by earnings on China's rapidly growing net foreign assets. With continued capital inflow, this has taken Chinese foreign exchange reserves beyond Japan's, to first rank in the world.

The small (1.9 per cent) appreciation of the yuan in mid 2005 has been followed by a low rate of currency appreciation—1.8 per cent against the US dollar to 18 August 2006—under the more flexible exchange rate system introduced at that time. This has been far too little to dent the external payments imbalances. The expansion of real domestic demand and imports has become an urgent matter. It is important for the quality and the value to China of relations with major trading partners, especially the United States. It is also important for domestic reasons: such expansion would be achieved with much less risk to currency appreciation, in the absence, and to remove a source of inflationary and destabilising monetary expansion.

The greater part of Chapter 2 examines the evidence of growing labour scarcity in rural and urban areas. Real wages in dynamic industrial cities have been drawing attention for some time. Over recent times, awareness of labour scarcity and rising wages has become widespread. It is driven by continued rapid economic growth in the cities, and in rural areas by emigration. The labour scarcity and pressures for rising wages will intensify rapidly. The absolute size of the labour force is growing slowly and will soon become negative; emigration has taken pressure off rural resources and raised the income levels that are necessary to attract more migrants; the labour force itself will soon be ageing, reducing the supply of young unskilled workers who have provided much of the requirements of rapidly growing labour-intensive industries; and rapidly increasing per capita investments in education are reducing the proportion of the labour force that is available for low-skill employment in manufacturing, construction and urban services.

Nicholas Lardy (Chapter 5) and Fan Gang (Chapter 6) discuss the external dimensions of China's contemporary economic challenge, in particular the large and increasing United States' current account deficit, the large and increasing Chinese current account surplus, and the immense and expanding US bilateral deficit with China. They approach the issues from different directions, and at first sight reach contrasting positions on the appropriate international policy response to the imbalances. But a closer look reveals some important common elements both in analysis and prescription, with recognition that each of China and the United States must accept part of the responsibility for adjustment, and that the correction of the imbalances will require some Chinese currency appreciation. At this stage, they maintain vastly different views on proportions of adjustment for which each country will have to accept responsibility, but over time this gap, too, will be reduced by increased knowledge about emerging structural changes in China.

Lardy analyses the bilateral imbalances in United States-China economic relations that has generated high levels of bilateral tension, and the multilateral imbalances in which China plays an important role. He dismisses some of the standard American and Chinese positions in the arguments about whether the imbalances should be the focus of policy concern and correction. There will be no solution to problems of United States deficits that do not involve adjustment on the American side. However, there are still powerful reasons why large appreciation of the yuan is required—much larger than is currently considered a possibility by anyone in China.

Fan (Chapter 6) takes a different view on United States-China imbalances, but draws some similar conclusions about desirable adjustments in Chinese policy. Fan notes that the fact that the United States dollar is the international as well as a national currency loosens the application of the normal fiscal and monetary disciplines on that country. That tempts it into more expansionary policies than it would otherwise choose, for which the whole world pays some price. One consequence is an extraordinary current account deficit with the whole world. It looks like a deficit in trade with China, but this view ignores the fact that China's manufactured exports draw components from the whole of Asia, and that as a result many other Asian countries run bilateral surpluses with China.

Fan's long-term solution would be the use of an international currency, or failing that, and pending the emergence of the conditions under which it could play a role, an Asian currency. The political environment for Asian monetary cooperation is currently favourable, with China and Japan sharing perspectives and objectives in relation to it. An Asian currency would take pressure from the bilateral relationship between China and the United States, but would not remove the need for adjustment within the United States.

Fan comments that a large part of the recent surpluses in the Chinese balance of payments is the result of speculative capital inflow that could be temporary. The structural part—the current account surplus—has grown a great deal last year and this because policy has been geared to bringing overinvestment to heal, reducing imports as a result. This part of the analysis is undoubtedly correct: tightening credit exacerbates external payments surpluses, which would now be somewhat lower if there were had been no attempt to reduce investment.

What, then, is the rationale of Chinese attempts to slow economic growth by tightening credit and reducing investment? At one level, it is driven by a view that the 'natural' or non-inflationary rate of growth of the Chinese economies is well below the recent 10 per cent plus levels—perhaps near the official 'target' of 7.2 per cent per annum, or perhaps a bit above 8 per cent. For those who hold this view, the recent increases in wages are evidence of overheating, requiring a monetary policy response. An alternative view, more easily reconciled with contemporary Chinese reality, is that with China's high levels of investment, and the rapid lift in productivity that is being driven by continued reform and integration into the international economy, the 'natural' rate of growth may well be 10 per cent per annum or higher. Within this view, rapid increases in real wages are a normal accompaniment of rapid growth at the turning point in economic development. If attempts are made to hold growth rates below the 'natural' levels, the main consequence will be unnecessarily to delay rises in Chinese living standards. At least in the short term, they exacerbate external trade and payments surpluses. The payments surpluses lay the basis for inflationary expansion of domestic money supply.

Wang (Chapter 3) mentions another reason why the authorities have sought to reduce investment levels: it is feared that they will generate excess capacity, generating financial and other sources of instability. Wang observes that the current evidence points less ambiguously to underconsumption than to overinvestment.

Guonan Ma (Chapter 7) and Jinzhi Tong and Wing Thye Woo (Chapter 8) discuss one of the critical determinants of the sustainability of strong economic growth in China: the problems of bad loans in the banking system, who will be required to meet the cost of managing the problem, in particular its cost to the budget, and the compatibility of the fiscal burden with future economic stability.

Ma's authoritative assessment of the bad loans problem draws some strong conclusions about the cost to be borne by elements of Chinese society, and by foreign purchasers of shares in Chinese banks. The eventual cost may reach 30 per cent of GDP. Credible corrective action has been taken since the late 1990s, but greater transparency is required in future action if the resolution of the banking problem is to maintain community support. The largest problems are in the state-owned banks in which taxpayers are the repository of responsibility, although foreigners have been prepared to share a substantial part of the burden as the price of buying equity in the franchise value of the banks. To date, taxpayers have carried 85 per cent of the costs, and foreigners the balance. The increasing role of direct foreign investment has raised the quality of the banking system, and reduced the risk of continuing deterioration in asset quality.

Tong and Woo focus on the interaction between Chinese demography and fiscal policy, and the intergenerational distributional consequences of current budget policies. The fiscal burden of the banking system problem is highlighted. The correction of the current extent of the banking system problem is consistent with manageable future fiscal burdens. However, a failure to arrest now the systemic weaknesses that have generated the current problems could tip the balance towards fiscal instability.

Cai Fang and Dewen Wang (Chapters 9), Yang Du, Robert Gregory and Xin Meng (Chapter 10) and Jane Golley and Rod Tyers (Chapter 11) are situated in the labour market, which is at the centre of the turning point in China's economic development.

Cai and Wang explore the links between China's integration into international markets, and growing demand for labour and wages in rural China. In the early twenty-first century, Chinese trade policy adjustments on entry into the World Trade Organization (WTO), and the rapid restructuring of business ownership away from state-owned and collective enterprises had been expected to place downward pressure on employment. The opposite turned out to be the reality. Rapid expansion of self employment and private enterprises outweighed the loss of jobs in state-owned and collective enterprises. However you look at it, urban employment grew strongly and unemployment fell through the early twenty-first century. Agricultural employment growth eased, but only because it was a buffer, that absorbed more labour during the weaker labour demand conditions during and in the years following the Asian financial crisis. One factor behind buoyant labour market conditions was the shift in the structure of Chinese production and exports towards China's comparative advantage in labour-intensive products, and away from comparative disadvantage in natural-resource based products, in the years of deepening integration into the international economy that followed entry into the WTO.

China is now moving quickly towards a declining labour force, and especially the young and unskilled component of the labour force. On modest assumptions about future growth, and relatively low employment elasticities of output, China is heading rapidly towards severe labour shortages at current real wage levels and economic structure. The consequence will be rising wages and evolution of industrial structure towards more capital-intensive production. The labour shortage that had been apparent in the heartland of internationally oriented growth in 2003—in the Pearl River delta—is now apparent in provinces that are sources of migrant labour. Chinese wages are rising much more rapidly than other countries, and will improve the competitive position of other Asian developing countries in global markets for labour-intensive products. The growing scarcity of labour will place pressure on artificial barriers to labour mobility and increase demands for labour rights in many forms.

Du, Gregory and Meng draw attention to the remarkable fact that China is the only country to have a system of 'guest workers' for its own citizens. There are about 120 million migrant workers in China's urban areas—about one third of the urban labour force, and likely to double in number over the next 10 to 20 years. These are not poor in income terms. But they and their families are denied a range of basic services. Their average incomes are reasonably high because they work much longer hours than urban residents, and go back to the villages if they fall on hard times in the cities. The balance of advantages is likely to shift against the guest worker system over time, for reasons of equity and efficiency, amongst other things because it inhibits the rural–urban migration that can raise incomes in the village and expand the labour available for higher value activities in urban areas.

Golley and Tyers (Chapter 11) use the well-known GTAP model to explore the relationship between demographic change, income levels and employment. It deepens our perspective on the role that the Chinese Government's anti-natal policy in the reform era has played in establishing the conditions for growing labour scarcity that are important in the contemporary Chinese economy. It models the effects of a range of adjustments in policy and response to them, concluding that higher fertility will not necessarily lead to greater economic welfare.

Chen Chunlai (Chapter 12) begins with an application of the theory of comparative advantage to China's situation. Chen notes that rapid economic growth in an economy with China's resource endowments can be expected to expand net imports of agricultural products and turn the country into a net importer. Trade liberalisation and deepening integration into the international economy can be expected to expand net imports of land-intensive agricultural products, and to expand net exports of labour-intensive products. Detailed empirical analysis demonstrates that the restructuring of Chinese agricultural production and trade has been proceeding rapidly along the lines suggested by theory since China entered the WTO in late 2001.

Yang Yao (Chapter 13) explores an important but so far little discussed dimension of the turning point in economic development: the emergence of greater popular participation in governance with the increase in incomes, education and the self confidence of ordinary Chinese. Yao's careful examination of village elections since their first introduction in 1987 and extension in 1998 shows that the village election has improved village governance and the welfare of the villagers.

Ross Garnaut and Ligang Song (Chapter 14) discuss the increase in Chinese demand for energy and metals that has accompanied rapid economic growth, urbanisation and the shift in industrial structure towards more capital-intensive activities. Growth and structural change have caused China to be by far the most important source of growth in global demand for these products over the early years of the twenty-first century. This has changed the balance between supply and demand in global markets, to the point where continued economic growth is likely for many years to keep world prices well above the levels of the last quarter of the twentieth century.

Bao Qun and Shuijun Peng (Chapters 15), Xunpeng Shi (Chapter 16) and Warwick McKibbin (Chapter 17) explore the important relationship between environmental amenity and economic growth. Economic growth in China in itself places pressure on global and local environmental conditions. It also increases concern for the environment, and causes people to be prepared to allocate more of their potential increase in incomes and consumption to environmental improvement.

Bao and Peng (Chapter 15) show that Chinese valuation of environmental amenity in relation to other dimensions of material welfare is rising, at measured income levels that are low compared with those that have triggered a big increase in concern for environmental amenity in other countries. However, there is room for acceptance of considerable further deterioration of environmental amenity before improvement becomes imperative.

Shi (Chapter 16) discusses the vexed question of the coal industry's contribution to the environmental impact on China's growth. While the intense and increasing use of coal is a source of huge negative environmental impact, the experience of Europe and North America, and the conditions in China, make it likely that coal will play a large part in China's energy future. This places a large premium on technological and other developments that reduce the negative impact of coal use.

McKibbin (Chapter 17) concludes with incisive analysis of one of the great international issues of our times, affecting the future condition of humanity in fundamental ways. China's contribution to global climate change is immense, and will grow in future. China is already the world's second largest source of carbon dioxide emissions, and is expected to account for a quarter of the growth in global emissions in the years ahead. There is no solution to global warming problems that does not encompass China and other large and rapidly growing developing economies. McKibbin suggest expedients that hold out prospects for improving the trade-off between economic growth in China and global environmental amenity.