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A Transforming China:
The Challenge of the 'Middle-Income Trap'

While China's Finance Minister Lou Jiwei has cautioned his country against slipping into the so-called 'middle-income trap', Chinese President Xi Jinping's sense of confidence during his recent State visit to the United States signals a different prognosis.

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China is changing- inevitably and inexorably. Napoleon Bonaparte would have preferred the Chinese dragon to continue to slumber. For when it awakes it will move the world, he had predicted. He was, as he was often wont to be, remarkably astute. China is waking now, or is already wide awake, as many would argue. We see the current powers struggling to adjust. There are still those who see this ancient civilisation in classical terms. As reflected in Liang Kai's painting 'The Sixth patriarch cutting bamboo'. Their numbers are unsurprisingly shrinking. But is China today, looking for, as Kaiser Wilhelm the Second sought for pre-Great War Germany 'ein Platz an der Sonne - A place in the Sun? Not so, the Chinese will retort. Merely *dingwei*, or 'global repositioning'.

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The Chinese leaders like to express themselves in maxims and metaphors. Nowadays, almost invariably in modest terms. The revolutionary fervour of describing antagonists as 'running dog lackey of capitalist-imperialist oppressors' has cooled considerably. Such expressions have all but disappeared from Beijing's political lexicon. The Chinese would not even admit to their country being on the 'rise'. For a while they toyed with the phrase 'peaceful rise' (*heping jueqi*). Ultimately they settled for a far more demure 'peaceful development'. But the 'softness' of language often conceals, as opponents soon discover, the 'hardness' of strategy to achieve purpose. The world is getting used to this cultural paradox.

The Chinese system has mastered the art of evolving through trials and errors. Chairman Mao Zedong led the revolution in 1949, and got the nation to eventually 'stand up', albeit at a steep price. He guided it as the 'great helmsman' often through most turbulent waters. For instance, during the 'great leap forward' or 'the cultural revolution'. The State and the Communist Party of China were firmly established. In the late-1970s, and through the 1980s, Deng Xiaoping, as 'paramount leader', led China through far-reaching market economy reforms. He believed that it did not matter 'if the cat was black or white' as long as it caught the 'mice'. By the 1990s, China became one of the fastest growing economies in the globe, "the world's most successful development story" according to Joseph Stiglitz. Eventually, by the time Xi Jinping, the current 'strongman', came to office, 439 million people had been lifted out of poverty. Undeniably, it was an unsurpassed feat in the litany of human development achievements.

The ride to the goals has not been a smooth one. This was not unexpected. The nature of the state was altered. Efforts were redoubled to keep the party relevant and accord it a *raison d'etre.* For reasons, domestic and foreign, the double-digit growth rate could not be sustained. Still the near-7% achievement in this regard has been the envy of the world. There has been some soft-pedalling of the candidacy of the 'yuan' to be a part of global reserve currencies. But some experts believe that the Chinese policy to that end will continue to be pursued. Recently Beijing adopted some measures many had been urging. It loosened its grip on the 'yuan', reined in the growth rate, allowed stocks to fall (though when they appeared to tumble, there were some State actions aiming to stabilise), and confronted corruption head-on. One would have thought that analysts, mainly, Western, would be pleased no-end. These steps were in line with market dictates. Yet they produced both anxiety and angst. Understandably, because the reality of China's slow-down was a fact that was fraught with most uncertain consequences. The Chinese sought to dispel the worries by claiming that the fundamentals were strong.

This claim has some merit. The export-driven growth had reached optimal level. New determinants of change were being introduced. These included domestic consumption (in that huge market) and foreign direct investments. The transition was not an easy one. The Chinese leaders have not fought shy of telling the world when the going was not necessarily good. It is worth remembering that, in December 2010, the principal foreign policy official, State Councillor Dai Bingguo offered a view. He stated that the world must not exaggerate China's rise, and must take into account the enormity of the challenges China still faced. It was extraordinary in terms of its frankness. This is in much the same way as the current Finance Minister Lou Jiwei analysed with disarming lucidity the state of the Chinese economy at a speech at Tsinghua University on 24 April 2015. In his speech Lou warned that China has a 50% chance of falling into the 'middle income trap' within the next 5-10 years.

According to the International Monetary Fund (IMF) the 'middle-income trap' is a phenomenon of hitherto-rapidly growing economies stagnating at middle-income levels and failing to graduate into the ranks of high-income countries. The Organization of Economic Co-operation and Development (OECD) in a report has stated that, in the last decade, 28 new countries reached the middle-income status. This is broadly seen as gross national per capita income stretching from US$ 4,100 to US$ 1,270. China's is US$ 7,500, or thereabout, placing it squarely in that bracket. Only 12 of those 28 graduated to higher income status during that period. The rest seemed to be locked into that level.

In Asia, apart from Japan, a developed economy for a long time now, four 'tigers' appeared to have succeeded in doing so. These are South Korea, Taiwan, Singapore and Hong Kong. In some assessments, they were able to do so by transforming their growth models and building four pillars for an 'innovative economy' in each case: One, competition and 'creative destruction' (the latter term, coined by Joseph Schumpeter around 1842, refers to the incessant product- and process-innovation mechanism by which new production units replaced outdated ones, an essential fact about capitalism); two, high education and top-notch Research and Development (R&D) capabilities; three, a dynamic labour market system; four, a financial system comprising venture capital, private equity, and securities market.

In his speech, Lou Jiwei, once a protégé of Premier Zhu Rongji and having, under that reformist leader, played a part in overhauling China's complex tax system and managing internal investments, made several bold assertions. He stated that comprehensive reforms were necessary to raise the urban labour supply in order to avoid falling into the middle-income trap, and ensure a 6.5% to 7% GDP growth in the next few years. He argued that China's contract law was flawed as it reduced the labour market's liquidity and flexibility by not allowing bosses to fire their workers. In a country of demographic decline and drop-productivity, it was important to keep wage increases below the growth in productivity (China has reached the 'Lewis Turning Point', which means it has run out of surplus rural labour, requiring rebalancing and strategic redeployment).

Lou's most significant, and therefore also controversial, comments focussed on agriculture. To-date food autarky or self-sufficiency has constituted a basic Maoist tenet, dating back to war-related apprehensions. It is still a firm faith with the more traditional military and planning communities. Lou criticised subsidies that encouraged farm-labour to stay with inefficient production. Lou saw value in shifting this extra labour to manufacture and services sectors, and making up for any food shortages, if at all, by simply importing. Other countries will continue to produce for the Chinese market, he underscored. Just as Argentina would, which devotes 40% of its fertile land to the production of soybean for China.

Lou had touched a hornet's nest. There was instant response. Much of it was criticism. South China Normal University Economics Professor Hu Jing took the position that this would endanger China's lifeline of food safety. He feared the turmoil that a sudden shortage of domestic grain supply, as a result, might cause. Another analyst, Huang He, wrote in 'Ground Breaking', a website that seeks to represent China's disadvantaged, that: "I understand his point is to meet the demand of capital increment by sacrificing workers' interests; but such a solution leaves China's labourers mired in low income and benefits capitalists in developed countries instead". Lou was, however, egged on by sympathetic commentators as well. A senior researcher at HSBC Bank, Qu Hongbin saw China as having to fight a critical battle to avoid the middle-income trap. According to him: "The successful experiences of Japan, South Korea, Taiwan, and Singapore show that consistent industrialisation and urbanisation [are] the correct path to follow and fortunately China has been heading in the right direction".

But the Finance Minister's candid views notwithstanding, what are the chances of China really getting stuck in a situation of such middle-income stagnancy? Right now, the odds appear somewhat stacked against it. True, China's workforce is shrinking: in 2014 the working age population, between 16 and 59 years, continued to fall by 3.7 million to 915.8 million.

Nonetheless in contrast to the previous generations' poorly-schooled workers, due to reasons such as the 'cultural revolution', China in 2015 is likely to produce 7.5 million graduates, who meet the highest educational standards. An economist at Barclays, Yiping Huang, is of the opinion that, by narrowing the technological gap with the advanced economies, China should be able to reach high economy status. He underscores: "Science and technology have taken off… China is breaking away from its old growth model. Long awaited structural improvements, including a narrowing of the current account surplus, a growing contribution of consumption to GDP and declining inequality, are already underway, but (as yet) may be unappreciated by investors…" A recent study by Barry Eichengreen of the University of California, Berkeley, Kwanho Shin of the Korea University, Seoul, and D Park of the Asian Development Bank, Manila, has pointed out that China has been doing slightly better than average in moving up the technology ladder in order to avoid the middle-income trap.

There is also the point of view, it is worth mentioning, that there is no such thing as a middle-income trap. The *Economist* called the idea a 'clap-trap', arguing that theory and evidence behind it is thin. In a piece entitled 'There is no Middle income Trap' Maya Eden and David Bulman point out that the existence of such a trap implies that growth rate systematically slows down as countries reach middle-income levels, but in reality no such slowdown is apparent in the data. They also show that middle-income countries grow faster than their peers by transformation to industry, low inflation, rising exports and reduced inequality which will produce stronger growth. They extrapolate that, not that countries cannot be trapped at middle-income levels, but simply that traps at middle-income levels are not more likely than traps at other income levels (low-income levels?).

There are lessons in this for another rising power in Asia, India, on which and on whose new leader Narendra Modi the eyes of the world are focussed. India with its per capita GDP of US$ 1,627 (Pakistan with US$ 1,343 even less so) is not within the high- or even the middle-income radar as of now, but a favourable set of positive policies should put it on the appropriate path. Be that as it may, the important point is not whether China gets caught in a theoretical middle-income trap, but whether its growth and development become stunted in a manner so as to impede its global role, as that of, in the words of the former US Deputy Secretary of State Robert Zoellick, a 'responsible stakeholder'. No substantial evidence points to the contrary. Indeed it was to make this point that the Chinese President Xi Jinping, addressing the 70th session of the United Nations General Assembly on 27 September 2015, pledged US$ 2 billion as an initial investment to help poorer countries reach the just-agreed Sustainable Development Goals (SDGs of which there are 17 in number), increasing it to US$ 12 billion over the next 15 years (2030). Mr Xi apparently feels confident enough to assertively pursue his “China Dream” (*Zhongguo meng*), and with the United States “a new type of great power relationship” (*xin xing dagou guanxi*). This implies eschewing, albeit in a nuanced fashion, modesty, and viewing itself as a ‘great power’ on the global scene. To paraphrase an old Chinese saying, we live in changing times!

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