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How China could yet fail like Japan

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Until 1990, **Japan** was the most successful large economy in the world. Almost nobody predicted what would happen to it in the succeeding decades. Today, people are yet more in awe of the **achievements** of China. Is it conceivable that this colossus could learn that spectacular success is a precursor of surprising failure? The answer is: yes.

Japan's gross domestic product per head (at purchasing power parity) jumped from a fifth of US levels in 1950 to 90 per cent in 1990. But this spectacular convergence went into reverse: by 2010, Japan's GDP per head had fallen to 76 per cent of US levels. China's GDP per head jumped from 3 per cent of US levels in 1978, when Deng Xiaoping's "reform and opening up" began, to a fifth of US levels today. Is this going to continue as spectacularly over the next few decades or could China, too, surprise on the downside?

It is easy to make the optimistic case. First, **China** has a proved record of success, with an average rate of economic growth of 10 per cent between 1979 and 2010. Second, China is a long way from the living standards of the high-income countries. Relative to the US, its GDP per head is where Japan's was in 1950, before a quarter century of further rapid growth. If China matched Japan's performance, its GDP per head would be 70 per cent of US levels by 2035 and its economy would be bigger than those of the US and European Union, combined.

Yet counter-arguments do exist. One is that China's size is a disadvantage: in particular, it makes its rise far more dramatic for the demand for resources than anything that has gone before. Another is that the political effects of such a transformation might be disruptive for a country run by a Communist party. It is also possible, however, to advance purely economic arguments for the idea that growth might slow more abruptly than most assume.

Such arguments rest on two features of China's situation. The first is that it is a middle-income country. Economists increasingly recognise a "middle-income trap". Thus, sustaining rapid increases in productivity and managing huge structural shifts as the economy becomes more sophisticated is hard. Japan, South Korea, Taiwan, Hong Kong and Singapore are almost the only economies to have managed this feat over the past 60 years.

Happily, China has close cultural and economic similarities with these east Asian successes. Unhappily, China shares with these economies a model of investment-led growth that is both a strength and a weakness. Moreover, China's version of this model is extreme. For this reason, it is arguable that the model will cause difficulties even before it did in the arguably less distorted case of Japan.

Premier Wen Jiabao has himself described the economy as "unstable, unbalanced, unco-ordinated and ultimately unsustainable". The nature of the challenge was made evident to me during discussions of the 12th five year plan at the **China Development Forum 2011** in Beijing in March. This new plan calls for a sharp change in the pace and structure of economic growth. In particular, growth is forecast to decline to just 7 per cent a year. More important, the economy is expected to rebalance from investment, towards consumption and, partly as a result, from manufacturing towards services.

The question is whether these shifts can be managed smoothly. **Michael Pettis** of Peking University's Guanghua School of Management has argued that they cannot be. His argument rests on the view that in the investment-led growth model, repression of household incomes plays a central role by subsidising that investment. Removing that repression – a necessary condition for faster growth of consumption – risks causing a sharp slowdown in output and a still bigger slowdown in investment. Growth is driven as much by subsidised expansion of capacity as by the profitable matching of supply to final demand. This will end with a bump.

Investment has indeed grown far faster than GDP. From 2000 to 2010, growth of gross fixed investment averaged 13.3 per cent, while growth of private consumption averaged 7.8 per cent. Over the same period the share of private consumption in GDP collapsed from 46 per cent to a mere 34 per cent, while the share of fixed investment rose from 34 per cent to 46 per cent. (See charts.)

Professor Pettis argues that suppression of wages, huge expansions of cheap credit and a repressed exchange rate were all ways of transferring incomes from households to business and so from consumption to investment. Dwight Perkins of Harvard argued at the China Development Forum that the "incremental capital output ratio" – the amount of capital needed for an extra unit of GDP – rose from 3.7 to one in the 1990s to 4.25 to one in the 2000s. This also suggests that returns have been falling at the margin.

If this pattern of growth is to reverse, as the government wishes, the growth of investment must fall well below that of GDP. This is what happened in Japan in the 1990s, with dire results. The thesis advanced by Prof Pettis is that a forced investment strategy will normally end with such a bump. The question is when. In China, it might be earlier in the growth process than in Japan because investment is so high. Much of the investment now undertaken would be unprofitable without the artificial support provided, he argues. One indicator, he suggests, is rapid growth of credit. George Magnus of UBS also **noted** in the FT of May 3 2011 that the credit-intensity of Chinese growth has increased sharply. This, too, is reminiscent of Japan as late as the 1980s, when the attempt to sustain growth in investment-led domestic demand led to a ruinous credit expansion.

As growth slows, the demand for investment is sure to shrink. At growth of 7 per cent, the needed rate of investment could fall by up to 15 per cent of GDP. But the attempt to shift income to households could force a yet bigger decline. From being an growth engine, investment could become a source of stagnation.

The optimistic view is that China's growth potential is so great that it can manage the planned transition with ease. The pessimistic view is that it is hard for a country investing half of GDP to decelerate smoothly. I expect the transition to slower economic growth and greater reliance on consumption to be quite bumpy. The Chinese government is skilled. But it cannot walk on water. The water it is going to have to walk on over the next decade is going to be choppy. Watch out for the waves.

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