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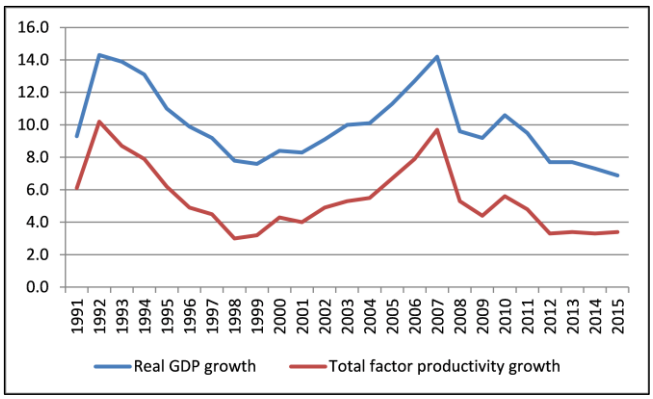
Is the Chinese "Economic Miracle" Over?

Since initiating free-market reforms in 1978, China has been one of the world's fastest-growing economies, averaging 9.7% in real gross domestic product (GDP) growth annually from 1979 to 2015 and lifting 660 million people out of extreme poverty, according to the World Bank. In 2014, China overtook the United States as the world's largest economy on a purchasing power parity (PPP) basis, according to the International Monetary Fund (IMF).

Over the past few years, however, China's economy has slowed. Its real GDP growth was 7.3% in 2014 and 6.9% in 2015, and is projected by the IMF to fall to 6.0% by 2017. China's merchandise trade, once the main engine of the country's economic growth, also has stagnated. In 2015, China's exports and imports fell by 2.7% and 18.4%, respectively over 2014 levels. China's slowing economy appears to have had a negative impact on the global economy, especially among countries that rely heavily on commodities (e.g., oil and ores) trade with China.

Figure 1. China's Annual GDP and Total Factor Productivity Growth (%)



Source: Economist Intelligence Unit (EIU).

China's slowing GDP growth rate has sparked a broader debate about the state and direction of the Chinese economy. Some analysts contend that China's "economic miracle" of consistent rapid economic growth may be ending and that it could be heading toward a much slower long-term GDP growth trajectory. Some even claim that current economic conditions in China may be worse than acknowledged by the Chinese government and warn that China could be headed toward an economic crisis, based on a number of recent factors:

- In November 2013, the Chinese government announced it would initiate new economic reforms that would let markets play a "decisive" role in the economy. This announcement fueled expectations that China would move to improve the business climate for foreign firms and lessen the government's involvement in the economy. Yet, many U.S. business groups contend that major economic reforms have not been forthcoming.
- China's two main stock indexes, the Shanghai Stock Exchange (SSE) and the Shenzhen Stock Exchange (SZSE), rose by 54% and 119%, respectively, from January 5, 2015, to June 12, 2015, but then began to experience sharp declines. By August 25, the SSE and SZSE had each fallen by 43%. The Chinese government heavily intervened to halt the slide, restricting stock sales by firms and making large-scale purchases of stock. The SSE and SZSE exchanges generally stabilized afterward, and from August 25 to December 31, 2015, they rose by 19.4% and 32.0%, respectively. However, from January 4, 2016 to February 5, 2016, the SEE and SZSE declined by 16.2% and 17.4%, respectively. The extent of the government's intervention added new doubts among many analysts over China's commitment to market liberalization.
- On August 11, 2015, China's central bank announced new measures to improve the market orientation of its daily central parity rate of its currency, the renminbi (RMB). However, over the next three days, the RMB depreciated against the dollar by 4.4%, which may have contributed to increased volatility in global stock markets. Some analysts saw the RMB devaluation as a risky attempt to jump-start the Chinese economy.
- Many analysts contend that China's efforts to boost economic growth following the start of the global financial crisis resulted in large-scale investments that worsened over-capacity in many industries (such as steel) and led to the accumulation of heavy debt by Chinese firms, households, and government entities (estimated by McKinsey & Co at $28 trillion in mid-2014), which could, some argue, weaken the financial sector and undermine future economic growth.

Other analysts are more optimistic about China's economy. They argue that China is transitioning to a slower, yet more sustainable, economic model. But they note that China needs to implement new economic reforms to be successful.

China's Economic Model

China's rapid economic growth over the past three decades can largely be explained by efficiency gains that resulted when it began to move from a Soviet-style command economic model (where the government controlled nearly every aspect of the economy) toward a more market-based economy where market forces and competition played an increasingly important role in the distribution of resources. This was aided by China's opening the country to foreign investment (especially in labor-intensive industries because China had a very large and underutilized labor force), a reduction of trade barriers (especially after it joined the

World Trade Organization in 2001), the expansion of the private sector, and a significant reduction the state sector's role in the economy.

Economic reforms helped to generate unprecedented economic growth in China. However, the government's approach has produced a number of significant problems:

- Until recently, the government's goal essentially was to grow the economy as fast as possible regardless of the cost to create jobs and boost living standards. This approach meant that the government was willing to tolerate such things as severe pollution, official government corruption, heavily subsidized industries, and growing income inequality—issues the government now says threaten social stability.
- Although the Chinese government sees economic reforms as vital to growth, it also continues to promote the role of the state in guiding economic development, part of which is to assist and protect Chinese industries and firms deemed vital to China's economy.
- Various policies have led to an unbalanced economic system. China maintains an unusually high level of savings. Its gross national savings as a percentage of GDP in 2015 was 48.1% (the U.S. level was 14.2%). This is largely caused by the relative lack of a social safety net in China and limited investment options for its citizens. In addition, China has been heavily dependent on fixed investment for much of its economic growth. In 2015, China's gross fixed investment as a share of GDP (at 42%) was higher than any major economy (the U.S. rate was 16%), while private consumption as a percentage of GDP (at 39%) was lower than any major country (the U.S. rate was 68%).
- Many products that say "made in China" are assembled in China by foreign-invested firms, using imported components. The value-added that occurs in China is often relatively small. China has relatively few global brands, and most of its largest firms are state-owned. China's relatively weak enforcement of intellectual propriety rights and government industrial policies that seek to promote "indigenous innovation" often are seen as major innovation inhibitors for China.

The "Middle Income Trap"

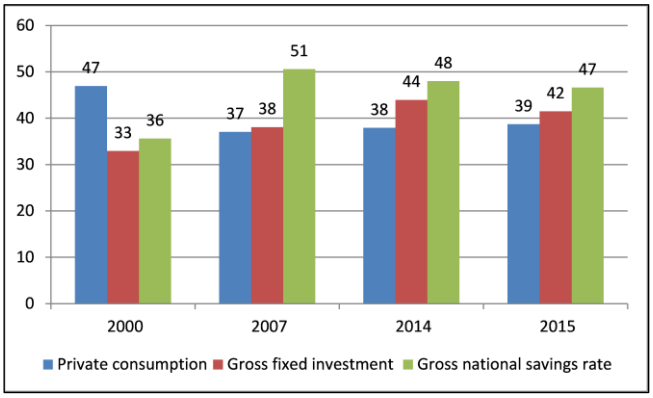
Several developing economies (notably some in Asia and Latin America) experienced rapid economic development and growth during the 1960s and 1970s by implementing some of the same policies that China has utilized to date to develop their economies, such as measures to boost exports and to promote and protect certain industries. However, at some point in their development, several of these countries began to experience economic stagnation (or much slower growth compared to previous levels) over a sustained period of time, a phenomenon economists described as the "middle-income trap." While several developing economies transitioned to a middle-income economy, defined by the World Bank as per capita gross national income (GNI) of $1,045-$12,746 in 2014 (using average exchange rates, adjusted for inflation), only a handful of countries (such as Japan, Taiwan, and South Korea) have maintained rapid economic growth long enough to become "high-income" countries (per capita GNI of $12,746 or more). Most other countries that reached middle-income levels saw their GDP growth rates decline, largely because they were unable to address structural inefficiencies in their economy or could not sustain productivity growth. China, now a middle-income country, may be at a similar crossroads. For example, China may be losing its advantage in low-cost labor. Its working population has reportedly fallen for three straight years (in 2015, it reportedly fell by 4.97 million people). A continued decline in China's workforce could drive up wages faster than productivity gains, thus potentially slowing the growth rate of real GDP. China already has experienced a slowdown in total factor productivity (TFP) growth in recent years. TFP grew at an annual rate of 3.6% from 2011 to 2015, compared with 6.6% average growth over the previous five years.

A New Economic Model for China?

Chinese officials appear to be aware of the economic challenges they face. In 2007, then-Chinese premier Wen Jiabao said China's economy was "unsteady, unbalanced, uncoordinated and unsustainable." China has indicated that it plans to rebalance the economy by making private consumption (rather than fixed investment) the main driver of its economic growth. The government also is seeking to reduce the economy's dependency on energy-intensive and high-polluting industries and to encourage high technology, green energy, and services industries. In addition, efforts have been made to expand China's social safety net (such as health care) to help reduce the need for high domestic household savings and thus boost private consumption. In 2012, services output overtook industrial output for the first time, and in 2015, they accounted for 50.3% of GDP,

Critics contend that while some economic rebalancing in China has occurred, much more remains to be done to boost private consumption (while reducing fixed investment and the high savings rate). Increasing the role of market forces in the economy (and shrinking the role of the state sector) and liberalizing trade and investment regimes are also viewed as critical to boosting long-term economic growth.

Figure 2. China's Savings, Fixed Investment, and Private Consumption as a Percentage of GDP (%)



Source: Economist Intelligence Unit.

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