



# Outlook for the Chinese Economy

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China is today confronting some major economic challenges, with the pace of its GDP growth slowing significantly over recent years in comparison with peak levels, at which growth rate was over 10%. In fact, China's real GDP growth rate for the April–June quarter of 2015 was limited to 7.0% year on year. The stock market in Shanghai is still suffering from the aftershocks of the significant plunge that occurred in July of 2015.

Regarding the official statistical data released by the Chinese government, quite a few analysts and other experts appear to share growing concerns that the pace of the country's recent economic growth remains, in reality, much slower than has been reported. In fact, the

Japan Center for Economic Research (JCER), a non-governmental research institute, estimates that China's GDP growth rate for the April–June period of this year fell to 4.8–6.5% year on year based on government statistics related to the country's electric generation capacity, the volume of freight transport, and bank lending, which provide a more realistic estimate of China's GDP for the period.

This suggests that the recent slowdown in the pace of China's economic growth should be interpreted not as a mere temporary phenomenon but rather as a more structural transition in



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China's economy from high growth to moderate growth. In other words, China appears to have little chance of getting back on track for high economic growth with 10% increases year on year. There are three main reasons to substantiate this view:

First, we see the “middle income trap” becoming more apparent in China as an economic phenomenon. Typically, a developing country tends to experience high economic growth during the initial years of its development. This is because the lower labor costs of the developing country help it to catch up with industrialized countries in terms of the economy. In the field of technology, the developing country can tackle the catch-up phase only by applying technologies already developed by industrialized countries.

However, as a country grows to reach a development stage where it is recognized as a “middle income country” with its level of income rising to a certain level overall, it becomes difficult for it to sustain catch-up growth. This is because it will be difficult for the low labor costs to remain as a primary source of competitive advantage for the country in conjunction with rising wages, and it will become increasingly important for it to develop products and services using its own technologies and creative ideas in order to achieve further economic growth. A smooth transition in economic status from a middle-income country to an industrialized country would not be possible without addressing the aforementioned new strategies and approaches to change the growth model. This is what the middle income trap is all about.

It appears that China is now on the verge of falling into the middle income trap, as the country has begun losing its competitive advantage against Vietnam and Myanmar in terms of labor costs following the substantial wage increases on the domestic front in recent years. Aside from the lackluster labor cost advantage in recent years, China does not appear to have seen any significant progress in its own technological development. This may well suggest that China's economic growth is about to reach a point where it starts tapering off in the long run, in much the same way that Japan's postwar high economic growth came to an end in the early 1970s.

The second reason is related to the bursting of the economic bubble. Over the last few years, China has continued to see the real estate market sizzling with the surge in stock prices. In particular, from the second half of fiscal year 2014, China's stock market rallied, despite its GDP and other economic



indicators suggesting a slowdown in the economy. It may well be said that the asset price increases seen in China recently can be interpreted as a speculative bubble that was formed beyond the country's economic fundamentals.

It will be hard to judge whether the rising asset prices truly represent an economic bubble or not, until it bursts. In the wake of the stock market crash in Shanghai that occurred in July this year, the Chinese government hammered out firm measures to prop up stock prices, but its efforts did not pay off at all. Given this situation, it may well be assumed that the soaring stock prices prior to the July market crash represented an economic bubble.

As can be seen from the case of Japan, the collapse of the bubble economy will typically leave banks and other financial institutions with books full of non-performing assets loans (i.e. bad debts on the part of corporate borrowers), resulting in the so-called balance sheet adjustment, which is usually caused by the events described in the following paragraphs.

During the period of the bubble economy, which is characterized by rising asset prices, corporate borrowing capacity increases while banks become willing to lend more to their corporate customers, which results in higher assets and liabilities on the balance sheet. When the bubble bursts and asset prices fall, the book value of the assets drops, leaving massive liabilities unchanged on the balance sheet. These massive liabilities mean excessive debts for corporate borrowers and non-performing asset loans for banks.

Companies with excessive debts find it hard to undertake business investments in a proactive manner. Meanwhile, banks saddled with bad loans become reluctant to enter into new lending deals. In this way, business investments are discouraged and economic growth ends up falling into a recession on both the demand and supply sides of the economy. This is exactly what happened in Japan after the collapse of the economic bubble, and the same types of events are likely to occur in China as well.

Third, aside from the aforementioned issues, the Chinese economy will be confronted with many other challenges. One of these is related to the environmental conservation and safety measures, which incur enormous costs. Environmental issues including air pollution have become major problems in China today, following its rapid industrialization. In August this year, a major explosion

occurred at a warehouse in Tianjin. As was revealed by this accident, hazardous chemical materials in China appear not to be handled safely. In order to address these problems, China will have to allocate an enormous budget to this area going forward, which in turn will prove to be counterproductive to the country's economy.

Another issue is related to China's political system. While China has been undergoing rapid liberalization in its economy, its political system continues to be based on a single-party regime. This intrinsic contradiction between growing economic liberalization and a rigid authoritarian one-party political system is so significant that I believe the Chinese government cannot afford to leave it unaddressed forever. Having said that, any attempt to change the current political system might lead to economic as well as social tensions on a large scale in China.

From a long-term perspective, China is undergoing a significant change in its demographic structure. In fact, its working-age population has already begun decreasing, which will eventually lead to a rapid rise in the elderly population in the near future. There is no doubt about this. If it turns out to be the case, the Chinese government will have to address the critical issue of who will support the elderly. This might also lead to significant socio-economic tensions in China if it is not addressed successfully.

It is often pointed out that the turning point in a country's economic growth is triggered by some kind of sudden event in society. As far as Japan is concerned, the first oil shock of 1974 served as the trigger. Until 1974, Japan's economy had been very strong, growing around 10% each year. In the wake of the oil shock, however, the country's economy stopped growing and never got back on track for high economic growth again. In the case of the Chinese economy, the recent stock market crash in Shanghai may serve as a trigger of a similar nature to change the growth trend.

In general, we need to take a range of innovative approaches to addressing these challenges.

One example of such approaches is that companies will enhance their capabilities to develop products and services on their own without relying on inexpensive manpower, while seeking to improve quality and achieve high added value instead of constantly trying to achieve economies of scale. In retrospect, Japan underwent a change in its industrial structure, oriented toward making high added value, energy-efficient products and services in response to the substantial rise in energy



prices caused by the oil crisis at the time. I believe that China must address a change of a similar nature in its industrial policy.

Another point is that China must promote structural reform in its economy. There is a consensus of opinion among Japanese economists that China must reform its state-owned enterprises, among other measures for the government to take. In order to implement a qualitative change in its economy, the Chinese government must encourage local businesses to develop their own technologies, products, and services at their own risk, while controlling it wisely. To make this happen, it must step up its approach to reforming the state-owned enterprises with the introduction of the private sector's corporate governance system on a larger scale.

Based on my observations as outlined above, I must say that China will see a setback in its economic growth in the near future.

I believe it will be important for China to see the expected economic setback as a springboard to achieve further reforms in its economic structure.

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Born in 1947. Graduated from the University of Tokyo and joined the Economic Planning Agency (currently the Cabinet Office), Japanese Government. Served as Director General of the Research Bureau at the Agency and Director General of the National and Regional Planning Bureau at the Ministry of Land, Infrastructure, Transport and Tourism. Has served as Professor at Hosei University since 2003. His publications include “Nihon keizai no kozotenkan (Structural reform of the Japanese economy)” and “Jinko fuka-shakai (Population onus society).”

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