



Guest Editors' Words

*Guanghua Wan, Peter J. Morgan**

China has been growing at an unprecedented rate since economic reforms were initiated in 1978, achieving an average annual real GDP growth rate of 9.7 percent over the entire period through to 2015. Even more remarkably, there was no marked slowdown of the decadal average growth rates, which stayed within the range of 9–10 percent in the three most recent decades. As a consequence, per capita GDP in 2005 purchasing power parity (PPP) terms reached approximately US\$11 300 in 2015, marking a remarkably successful transition from being one of the poorest countries to attaining upper-middle income status in just over one generation.

However, China's strong growth streak has recently run out of steam, showing steady and marked deceleration since 2010. By 2015, the annual growth rate had fallen to 6.9 percent, the lowest since 1990, when monetary policy was tightened sharply to reduce inflation. The slowdown has naturally raised concerns worldwide, mainly because China has been the largest engine of global growth for many years. Thus, this slowdown has significant, and in some cases crucial, implications for many economies, particularly for China's major trading partners.

Clearly, the key question is whether China's economy will continue to slow and the nation will be trapped in a slow growth mode, or whether its growth can re-accelerate. This was the theme of two conferences organized jointly by the Asian Development Bank Institute (ADBI), *China & World Economy* and the National Science Foundation of China (Project NSF 71133004).¹ A total of 58 papers were submitted and 30 were selected for presentation. These papers focus on the root causes of the current slowdown and, in light of these, assess the growth potential of the Chinese economy and the conditions under which that potential growth could be realized. Not surprisingly, there were both optimistic and pessimistic views on the outlook for the Chinese economy. This special issue of *China & World Economy* presents some of the most incisive analyses from these conferences.

The pessimistic and optimistic views divide along several key fault lines. First, when using growth accounting approaches to identify the supply-side determinants of

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¹“Implications of a Possible PRC Growth Slowdown for Asia,” 25–26 November 2015 in Tokyo, Japan and “Middle-income Trap in Asia and PRC New Economic Normal,” 13–14 April, in Beijing, China.

growth (i.e. the relative contributions of labor, capital and total factor productivity [TFP]), the optimists generally find that the contribution of TFP growth to GDP growth has been large. This is important because it implies that China's high growth rates are potentially sustainable as they have not depended on a rapid rise in the capital–output ratio, which would imply a sharp decline in the rate of return to capital. On the other hand, the pessimists tend to find that most of the Chinese growth can be attributed to capital deepening, which implies a substantial reduction of the return to capital, and, hence, is likely to limit potential growth going forward.

The second area of disagreement is whether the recent slowdown should be attributed mainly to domestic structural factors or to external and cyclical factors, with pessimists emphasizing the former and optimists the latter. Domestic structural factors include the aging of the population, the diminishing pool of surplus agricultural labor, declining return to capital, economic distortions such as preferential treatment of state-owned enterprises and factor-price distortions, and excess capacity. The third area of disagreement is the basis of comparison for assessing China's growth potential. Pessimists cite the findings of the convergence theory of growth, the so-called “iron law” of convergence, which predicts that growth slows to the global average, in line with the level of per capita GDP. On the other hand, optimists argue that China can follow the path of earlier Asian success stories, including Japan, Korea, Singapore and Taipei, China, which benefited from export-led growth strategies, high rates of savings and investment, and relatively rapid growth of human capital.

Barro estimates two models of long-term convergence of per capita real GDP. The first uses data on 89 countries from 1960 to 2010. For this model, the results imply a conditional convergence rate of 1.7 percent per year. The second dataset covers a much longer period, 1870–2010, but a smaller sample of only 28 countries. The second model yields an estimated conditional convergence rate of 2.6 percent per year. Barro argues that the true coefficient on the lagged dependent variable is probably bracketed by these two values.

Barro finds that China's recent growth rate is much higher than that predicted by his first model, and the results imply that China's per capita growth rate is likely to decrease from 8 percent to a range of 3–4 percent. However, he argues that this growth rate over a long period would still be sufficient to enable China to make the transition from middle-income to high-income status. Thus, although these more realistic growth rates are well below recent experience, they would still be a great achievement.

Lin, Wan and Morgan have the most optimistic view. They argue that China has many positive supply factors that, under favorable circumstances, could support a high potential growth rate. Most importantly, developing countries such as China possess a “latecomer advantage,” because they can achieve technological progress through

imitation, importing capital goods, integration, and licensing of technology. This capacity can enable China to substantially upgrade its industrial structure. In 2008, China's per capita income in 2005 purchasing power parity terms was just over one-fifth that of the USA. Based on the growth experience of Japan, Korea, Singapore and Taipei, China from the time when their per capita incomes were at similar ratios to that of the USA, they estimate that China has a potential growth rate of roughly 8 percent through to 2028. In addition, even though export growth may have slowed, there is still potential for high growth in domestic demand, including investment in urbanization-related investment, infrastructure, industrial upgrading and environmental improvement. For consumer spending, reform of the hukou system could permit freer internal migration toward higher-paying jobs.

Second, they attribute the recent slowdown mainly to cyclical and external factors. This does not mean that they deny that China faces important structural issues that need to be addressed. In fact, structural reforms are necessary to realize the 8 percent growth potential. The key challenge is to pace the reforms to achieve positive results while minimizing the short-term deflationary impacts, and to combine them with appropriate macroeconomic policies.

Wu finds that, of China's 8.9-percent annual GDP growth over the period 1980–2012, 7.0 percentage points (ppts) could be attributed to the growth of labor productivity and 1.9 ppts to the increase in hours worked. He finds that China's labor productivity growth was heavily dependent on capital deepening (5.7ppts) rather than TFP growth (0.8ppts). Notably, he estimates that TFP growth turned negative over 2007–2012, which raises the question of China's growth sustainability. Another key finding is that industries that are less subject to state interventions demonstrate faster TFP growth than those controlled by the state. Incorporating the Domar sectoral aggregation scheme, he finds that two-thirds of TFP growth originated from within industries and the remainder can be attributed to a net factor reallocation effect in which labor shifts played a positive role while capital appears to actually have shifted to less productive sectors. Finally, using a revised Maddison–Wu approach to address the potential flaws in official statistics, he arrives at an annual growth rate estimate of 7.2 percent, or 1.7-ppts slower than the 8.9 percent obtained based on the China Industry Productivity data reconstructed using the official national accounts.

Lee estimates the contribution of various growth factors to the growth rates of China, Japan and Korea. He also estimates a cross-country panel regression for per capita GDP growth using a sample of 75 economies over the period 1960–2010. His estimates of the conditional convergence rate for per capita GDP growth range between 1.7 and 3.4 percent per year, depending on whether or not country fixed effects are included, which is a somewhat wider range than Barro's estimate. Lee attributes Korea's

recent slowdown to its unbalanced economic structure and estimates that China's potential GDP growth will decline to 5–6 percent over the coming decades, unless institutions and policy factors are significantly improved. However, he notes that Korea and China share some favorable conditions for more rapid growth than other developing countries, including strong investment, high trade openness, macroeconomic stability, and continuous improvement of the quality of human resources and institutions. He argues that future reforms and policies might partially offset the growth deceleration due to convergence in the coming decades.

Yao also compares the experience of China with that of Japan and asks whether China might be subject to the “Japan Syndrome.” He finds a number of similarities between China and Japan, including an export-led growth model, upward pressure on the yuan and an aging population. However, he argues that the large internal disparities of income levels in China could contribute to growth if the poorer inland areas converge to the high income levels of the coastal regions. Based on the estimation of a growth equation using cross-country panel data, Yao forecasts that, under reasonable assumptions about the growth rate of the world economy and China's investment rate, China could maintain reasonably high potential growth rates in the next 10 years in the range of 6–7 percent.

Fukao and Yuan compare the experiences of China's and Japan's high-speed growth periods and the following periods, and derive some lessons from Japan's experience. First, compared with Japan, they find that China's high growth rate has been driven more by capital accumulation and less by TFP growth, which would tend to lower the rate of return on capital and might lead to an earlier end to China's high-speed growth period. Second, the fact that the labor-force-age population will decline at an earlier stage of development in China than in Japan will also tend to reduce the rate of return on capital. Taking these factors into account, Fukao and Yuan conclude that China's high rate of capital investment growth is unsustainable, and recommend that China speed up economic reforms to promote higher growth of TFP.

The debate will go on. However, some aspects are relatively clear. Exports are unlikely to provide a major source of growth for China, given the subdued state of global demand. The need to rely primarily on domestic demand points to the importance of carrying out continued reforms to support growth. These include reform of the hukou system to free up internal migration toward higher productivity jobs, reform of the financial system to direct capital resources to the areas of highest return, reform of state-owned enterprises to increase the role of competition, and reforms of distorted pricing mechanisms. Optimists believe that there is plenty of room to wring out efficiency gains to support future growth, while pessimists will fret about the challenge of overcoming the resistance of vested interests to such reforms.