

CAN CHINA ESCAPE THE MIDDLE INCOME TRAP?

LU Ding

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Executive Summary

1. After achieving spectacular hyper economic growth close to 10% per annum for three decades, China has recently joined the league of middle income countries. In the past, many countries of middle income status have stagnated and failed to keep growing to the level of development of advanced countries. Will China be able to escape this “middle income trap”?
2. Studies on growth accounting of the Chinese economy have revealed that about two-thirds of its hyper growth in the past three decades was driven by physical capital formation that amounts to 35%-48% of GDP, one of the fastest in the world.
3. The importance of this growth driver has even increased in recent years. The other important source of economic growth is the growing total factor productivity, the part of economic growth unaccounted for by the expansion of inputs like capital and labor.
4. Capital formation is set to slow down in the coming years partially due to the diminishing effects of some transitional factors that have boosted savings and investment. China’s working age population is reaching its peak around 2015.
5. Between 2010 and 2030, the youngest group aged 15-24 will fall by over 30% while the oldest group aged 60-64 will double its size. The demographic trends of a shrinking labor force and aging population will jointly work against capital formation by bringing in fundamental changes to savings behavior and capital returns.
6. With slowing capital formation, economic growth has to rely more on efficiency improvements and technological advancements. There is still ample scope for efficiency improvements through institutional reforms and urbanization. China’s superb achievements in human capital development and

persistent heavy investment in knowledge creation and technological progress bode well for continuous gains through technological advancements.

7. However, the median age of China's population will soon be over 35 years old, the level of Japan's in the late 1980s when its era of fast growth came to an end. China's fast aging labor force and rising burden of old-age support will increasingly be a drag on productivity growth.
8. Given the severity of environmental damages that already amount to 6-8% of annual GDP, it will be more difficult for the Chinese government to generate "cheap" economic growth at the expense of environment degradation.
9. With slower GDP growth, China's chance of avoiding the middle income trap hinges on its continuous convergence with advanced countries in productivity growth. China must thus optimize its advantages in human capital and scale economy to promote technical progress and efficiency improvement. That requires further policy and institutional reforms in favor of innovation, entrepreneurship, and urbanization.