China: Years of Decline?

By Hellmut Schütte , INSEAD

China's 2015 growth rate sent shivers through global markets, but the country added the equivalent output of Thailand and the Philippines to its economy last year.

China has been the unfortunate scapegoat for many of the world's economic distortions in recent years. Its unparalleled growth since 1980 threatened jobs in other markets. Its "socialist market economy" challenged orthodox believers in the efficiency of the (free) market. Its flexing of financial muscle in global bond markets questioned the premise that only advanced economies are rich, while emerging countries are poor.

Now that China seems to be in decline, worries are rising over its huge overcapacities, stock market turmoil and falling demand for raw materials. No wonder the rumblings about "hard landings" are back.

Such a large – and increasingly large – economy is bound to have knock-on effects on the rest of the world. But many point to China's model of economic management as if it is unusual, out of step with the way other large economies handle their business. But nothing of what we have seen in the past or that we are observing now is truly unique.

Today, China's economy is behaving in a rather similar way to most other countries. This is true even of the government's influence on industry which in some sectors is similar to what we see in some European countries such as France. China uses (thanks to the World Bank) the same measurement yardsticks for GDP, foreign trade, inflation, industrial output, etc. as almost every other country. As such, comparisons are possible and called for.

The new Normal

The recently announced growth rate of 6.9 percent for 2015 shocked the world, even though it is one of the fastest growing economies in the world. True, it is the slowest rate of growth China has seen in 25 years, indicating a decline. But translated into the dollar equivalent, the additional wealth created, in terms of income or production of goods, represents US$725 billion. This is the more than the combined GDP of Thailand and the Philippines. In other words, China in 2015 added the equivalent economic activity of two of the largest ASEAN countries to its own total output.

This is similar to Japan, which added the equivalent of the South Korean economy to its own GDP annually during its "bubble years." Large countries simply have an enormous momentum when their growth is high.

On a per capita basis, another worthwhile comparison can be made. In 2014, GDP per capita in China was US$7,600, growing by 6.9 percent in the following year. Assuming that no major revisions will be demanded by the World Bank, at the end of 2015, the average Chinese had about US$500 more in his or her pocket. This increase in income in actual dollars was in fact the largest the Chinese ever had in their history. Going back ten years, GDP per capita was US$1,500 and the growth rate 11.4 percent, which translated into income growth of only US$170. India showed higher growth than China in 2015. However, due to the low income base, the incremental increase was only about US$80. As such, the per capita income gap between the Chinese and Indians widened further. Assuming a moderate Chinese growth rate of 4-5 percent. India would have to see income per capita increases of at least 20 percent in order to close this gap, or at least not let it widen further in China's favour. This is a rather unrealistic expectation.

When will it be #1?

Will the average income in China reach the level of advanced countries soon? Probably not. This is because China still lags so far behind, arguably due to long periods of civil war and economic mismanagement before market reforms began in 1978/79. Given the present high income levels in the prosperous parts of the West, a growth rate of only 1.5 percent is enough to provide more additional income there per year than the average Chinese can enjoy while growing with high speed. A growth rate of 2 percent will increase the gap between the per capita income in those Western countries (such as the US) and that of the Chinese, even if the Chinese success story continues for a few more years.

Economic history tells us that the macroeconomic growth rates come down when income rises. Economists like to explain this phenomenon with productivity curves. Productivity improvements are much easier to achieve when its level is low, and productivity is the most important driver of the growth. Looking around in the region, Japan, South Korea, Taiwan, Hong Kong and Singapore provide ample examples of economies with very high growth rates at a certain take-off point, which consequently slowed down. In other words, while advanced countries might well be able to hold on to 1 percent to 2 percent growth, it will be very difficult for China to stay on the level of 7 percent or higher.

Will China become the largest economy in the world? Probably yes, without even applying purchasing power parity calculations. The total size of an economy consists of the size of the population multiplied by income per capita. Having more than 1.3 billion people in China versus 320 million in the US gives China a huge “population multiplier”. Even if on a per capita basis the Chinese cannot catch up with the Americans, they can in terms of total GDP. Assuming no major changes in other macroeconomic figures, that will happen when income per capita in China reaches one quarter of that of the USA. In 2014 the number in China was US$7,600 compared to the USA’s US$56,000. Although China’s productivity is increasing, it has a long way to go.

Do all these numbers matter to the business community? Yes and no. Yes, because the way one looks at numbers influences and shapes perceptions about business opportunities, investments and profit expectations. No, because companies operate based on their own capabilities in given geographies, industries and sectors which may have different dynamics than those found in the macro economy. However, a dose of perspective is needed when looking at China. Its growth may be slowing, but that was to be expected. It is neither unusual, nor unique.

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