China - the true risks to its future growth

Dr Woody Brock | SED | 29 July 2015

Investors should be wary of the category "emerging markets" if only because the fate of such economies is so variable. Many experiments end with low growth and economic distress – an investor's nightmare. Others deliver the goods of sustained rapid growth and high returns. China, for its part, is now assumed to have "emerged" given how remarkable its growth has been since 1980. But, in fact, it is still emergent, for reasons we shall see.

Investors find China very difficult to understand, due to its unusual combination of capitalism and communism. Its success seems a contradiction in terms to many. To cope with their confusion, investors understandably oversimplify what is going on in China, and have fallen into two opposing camps. On the one hand, there are the optimists claiming that (i) the Chinese government possesses the demonstrated ability to navigate the shoals of economic transformation better than any other economy on record; and, that (ii) they will continue to do so, and thus China will emerge as the greatest economy and indeed power on earth, eventually outstripping the US, which is plagued by secular stagnation and by its loss of purpose.

Pessimists on the other hand focus on the myriad shortfalls and contradictions within the Chinese economy – and, in particular, on the contradiction between an unfettered capitalist system held in the clutches of an all-powerful Communist Party cadre. They see a long-overdue collapse in growth now occurring, rising debt, social and political repression, and conclude that the Chinese miracle is over.

The purpose of this paper is to put China's economic ascension into proper perspective. to help investors better understand the nation's future prospects.

To anticipate, we believe China to be a glass that is both half full and half empty. China will continue to grow and become a great superpower, but its future growth rate will be significantly lower than today's "new normal" forecast. How low will depend entirely upon the quality of the policies it adopts going forward.

As we have stressed in discussing both Western and Japanese stagnation, the growth rate of any nation is very largely determined by the policies it adopts – its incentive structure, in particular. Consider first the West. The currently fashionable prediction of secular stagnation in the West implicitly assumes that today's low-growth policies will remain in place over the next couple of decades due to the unwillingness of politicians to adopt high-growth policies. But no such assumption need be made. For nothing precludes the advent of a Thatcher, a Reagan, a Keating, or a Lee Kuan Yew who will embrace high-growth policies. If and when such leadership arrives, fears of secular stagnation will subside. The same is true of China, where the degree of the deceleration of growth will depend upon the nature of the policies that are adopted, not merely upon demography.

But exactly which policies will permit China to grow as fast as possible?

THE GENERAL LOGIC OF GROWTH IN EMERGING ECONOMIES

The theory of growth in emerging markets dates from 1960 with the publication of Walt Whitman Rostow's Book, The Stages of Economic Growth: A Non-Communist Manifesto (Cambridge University Press, 1960). Rostow offered a description of five different stages that marked the transformation of traditional, agricultural societies into modern, mass-consumption societies. These five stages are summarized below. The main criticism of his work was that, while he convincingly described the evolution of economies from primitive to advanced, he offered no logic as to how to achieve the transformation he aptly described. More specifically, he did not offer a behavioral model of what societal changes were needed to motivate governments and citizens to act in such a way that rapid modernisation was achieved.

To be fair, in 1960, no logic had yet been designed as to what is required to achieve such motivation. This logic would be developed between 1960 and 1990 under the name of "mechanism design," a branch of economics and game theory stimulated by the pioneering work of the Nobel Laureate, Leonid Hurwicz.

We first sketch Rostow's descriptive theory of economic evolution, and we then sketch the policies required for this to be achieved as rapidly as possible. The bulletised summary that follows is taken verbatim from Rostow's book, and it also appears in Wikipedia.

Rostow's five stages of economic growth

1. Traditional Societies are characterised by:
   - Subsistence agriculture or hunting and gathering – almost a wholly primary sector economy;
   - Very limited technology, and a very limited stock of productive capital;
   - A static or rigid society: lack of class or individual economic mobility, with stability highly valued,
     and change viewed as threatening.
2. Preconditions for Take-off:
   - External demand for raw materials initiates economic change;

- Development of more productive, commercial agriculture and cash crops not consumed by producers but largely exported;
- Widespread investment in changes to the physical environment to expand production (e.g. irrigation, ports, canals);
- Increasing spread of technology, and advances in existing technologies;
- Changing social structure, with previous social equilibrium in flux;
- Individual social mobility takes off;
- Development of national identity and shared economic interests.

3. Take-off:
    - Urbanisation increases, industrialisation proceeds;
    - The secondary (goods producing) sector expands and the ratio of secondary to primary sectors increases rapidly;
    - Textiles and apparel are usually the first take-off industries.
4. Drive to Maturity:
    - Diversification of the industrial base occurs; multiple industries expand, and new ones take root quickly;
    - Manufacturing shifts from investment-driven goods (e.g. capital goods) towards consumer durables and domestic consumption;
    - Rapid development of transportation infrastructure;
    - Large-scale investment in social infrastructure (schools, universities, hospitals, etc.).
5. Age of Mass Consumption:
    - The industrial base dominates the economy. The primary sector is of greatly diminished weight in society and in the economy;
    - Widespread consumption of high-value consumer goods (e.g. automobiles);
    - Consumers with disposable incomes beyond those required for basic needs, making additional growth possible.

Rostow asserted that countries go through each of these stages fairly linearly, and he set forth conditions that were likely to occur in investment, consumption, and social trends at each stage. He pointed out that conditions vary from country to country, and that the time lags between the five stages will vary considerably.

DETERMINANTS OF THE RAPIDITY OF TRANSFORMATION

Some of the determinants of the rate of economic transformation are obvious – e.g. the extent of foreign investment and assistance, proximity of other advanced economies, stability of government, and the extent of natural resource endowments. What is less obvious and arguably more important is the perspective introduced by the new theory of "optimal mechanism design." Here the issue is – What arrangement of carrots and sticks will cause all parties involved (from peasants to politicians) to act in a way that maximises progress through Rostow's five stages of growth? To restate this, what "incentive structure" will optimise growth?

The answer to this question is quite counter-intuitive, and suggests for example that the extent to which a country has natural endowments (oil, iron ore deposits) is largely irrelevant to optimal growth. Let us cite a number of the insights from the new field of mechanism design that bear on optimal economic development.

1. From top-down to bottom-up growth

In the initial stages of growth (stages 2 and 3), one of the most important requirements is intense infrastructure investment of all kinds – roads, trains, dams, ports, electric power generation, etc. The most efficient way to achieve this very high level of infrastructure investment is via a command economy where those at the top order citizens to build X number of new pyramids in ancient Egypt, Y number of new dams in the Ural mountains of Russia, and Z number of new cities in China for the 500 million people "encouraged" to leave farms for cities. Consider China. Whether we think of its transformation from 1980 to 2000 as communist or capitalist does not matter. What matters is that the government conceived of a master plan for creating an entirely new civilization (with its attendant new cities, roads, ports) and executed this plan by fiat. What might have taken a democracy 80 years to achieve was achieved in a mere 20 years.

When stages 4 and 5 are achieved, however, a bottom-up approach to growth is then required. More specifically, by this stage, the boost from infrastructure investment has passed. Consumption must now replace investment demand as the key driver of GDP growth. Of course, if consumption is to soar, then the non-investment goods and services that are provided cannot efficiently be provided via a top-down command structure. Rather, demand and supply of consumer goods must be generated via a bottom-up structure. The issues that arise here are absolutely fundamental to the rate of growth, even if they are rarely discussed.

The rate of economic growth will now be directly proportionate to the rate of demand-and–supply growth generated via deal-making by small and medium-sized businesses – you and I decide to start a new venture, Tom and Sheila open a restaurant, Bert and Anne start up a new investment management firm offering pensions to workers for the first time, and so on. The very rapid growth for decades of Hong Kong, Singapore, Taiwan, and South Korea was generated via this bottom-up type. The greater the number of people who woke up in the morning and decided it was in their interest to start-up businesses and hire workers, the faster was the growth of both supply and demand throughout the economy.

Of course, many nations fail at this stage to do what is necessary to generate Hong Kong-like performance. Why? What do they fail to do that is required for rapid bottom-up growth? This is the $64,000 question that is too often overlooked, and it brings us to the next two sets of insights from mechanism design theory.

2. The Role of corruption

Consider two emerging nations, each entering Stage 4 growth. Nation A has very little corruption since the Rule of Law, the sanctity of contracts, and the protection of private property rights characterise the political economy of the nation. In this happy case, parties of any kind can enter into business deals with the confidence that their contracts and property rights will be upheld in court, and that no one party can "bribe the judge" to prevail over any other party in the event of a dispute. In nation B, the reverse holds true. In this latter case, how many citizens would take the risk of entering into deals with others – the true source of bottom-up growth? The incentive structure makes it irrational for most citizens to do so.

To give an example, suppose that the Rules of the Game (the incentive structure) in North Korea specify that you will be tortured if you are caught starting up a private business. Then neither you nor others will set up new businesses year after year, and long-run economic growth will be 0%. The altogether different Rules of the Game in South Korea favor business creation, and augur the rapid growth of enterprises and of consumption that we have witnessed for four decades – the true drivers of economic growth.

Note that the sharply divergent growth rates of these two sister nations have nothing to do with culture, a sloppy term that is often bandied about by economists who do not understand the all-important role of incentive structures in the economies of any culture. We have learned during the past five decades that the economic agents of every culture are remarkably alike – give individuals the opportunity to work hard, to invest, and create a better life for their children, and they will all do so.

There is a related but different way in which corruption slows growth. Optimal growth presupposes that capital is productively allocated when investment decisions are made, whether in the private or public sector. The moral is that roads, cities, and factories should not be constructed unless there are end users to pay the freight and reap positive returns. Conversely, while building "roads to nowhere" may create jobs in the short run, the lack of any end-use payoff causes bankruptcies and reduces growth. The situation is even worse if the mal–investment is funded by debt, for in this case there will be no future revenue stream to pay off the debt – bad debt, in this case. And. the greater the magnitude of bad debt, the slower growth will be.

portfolio construction forum

The underlying point here is that, the greater the extent of corruption, the more capital will be misallocated, with the result of lower economic growth.

3. Informational and decisional decentralisation, and the meed for an Invisible Hand

A final insight centers on the degree to which government intrudes upon the private sector, either by specifying product choice and output decisions, or by seeking too much information. The point raised here harkens back to the heated Lange-Lerner debate within economics in the 1930 to 1950 period. This centered on the competing virtues of central planning versus decentralised resource allocation mechanisms." The former was favored by the Left, and the latter by the Right. Interestingly, with the introduction of the mathematics of linear programming in the early 1950s, it was shown that, in principle, a master computer (government) possessing enough information about the preferences and endowments of consumers and firms could generate an efficient economic resource allocation just as the decentralised Adam Smith Invisible-Hand market mechanism could. In principle.

The joy of those on the Left was short-lived, however, when Leonid Hurwicz and others began to include informational and decisional efficiencies within the concept of economic wellbeing.[1]

To wit, the problem with central planning is that the master computer could only arrive at an optimal allocation of goods and services to all citizens if it contained vast amounts of information about every citizen's preferences and resource endowments. But government in reality could never accumulate such information, partly because of the time and cost involved in obtaining and updating such information, and partly because it would be in the self-interest of many players to misrepresent their true preferences and endowments.

For these reasons, rapid growth in Stages 4 to 5 of Rostow's taxonomy requires the remarkable informational and decisional decentralisation made possible in the Adam Smith Invisible-Hand model. In this model, no agent needs to know anything about the preferences and resources of any other agent – that is, the economy is completely informationally decentralised. I can choose to buy three pounds of chicken for my dinner party tonight, you can choose a leg of lamb, Tim can choose to vacation in Paris, and Sue can decide to tour Wyoming – with no one requiring permission slips from some master planner known as government. In this sense, all agents are free, and the system is said to be decisionally-decentralised.

It thus emerges as a theorem that optimal resource allocation and optimal growth in Stages 4 and 5 requires a decentralised, market-based system.

4. Fiscal and Monetary Policy

To read the newspapers, one would assume that rapid growth can result from good fiscal and monetary policy. To be sure, both fiscal and monetary mismanagement will wreak havoc with growth. As just discussed, fiscal deficits that do not fund good investments (but rather fund mal–investment or transfer payments) will lead to fiscal ruin of the kind we see in Greece and Argentina, and to dead growth. Monetary policies that do not target and achieve modest and stable inflation will undermine investor confidence and once again will lower investment and growth. So yes, good macro policies matter to growth.

This having been said, it is often forgotten that the macroeconomic monetary and fiscal policies proposed by Keynes were not intended to generate optimal long-run growth. Rather, such policies were aimed at moderating shorter-term business cycles. If private sector demand is dead, then appropriate fiscal and monetary policies can temporarily boost demand.

But such counter-cyclical policies will not generate high rates of long-run growth. For the latter, we must look to the incentive structure arguments raised above – arguments that barely get a hearing in today's era of Fed-watching and monetary policy hysteria. As the former head of Italy;s central bank recently stated: "No matter how low interest rates may go, growth will not return to Italy unless employers have the freedom to fire the workers they hire."

CHINA'S ASTONISHING ECONOMIC EMERGENCE TO DATE

China’s performance between 1980 and 2015 has been miraculous. What is interesting from the standpoint of this paper is that it has achieved a transformation from Stage 1 through Stage 4 growth in the least amount of time of any major nation in history. What has occurred matches Rostow's five-step sequence-of-transformations with uncanny accuracy. Interestingly, China not only transited from a very low to an unprecedentedly high level of investment spending, but also aggressively relocated over 500 million workers out of low-productivity farming jobs into higher-productivity jobs in urban areas – both prerequisites for rapid development in Rostow's theory.

Moreover, from the standpoint of incentive structure logic, China utilised the Communist Party's top-down command structure to achieve both comprehensive and extremely rapid development. Without its highly centralised command-and-control structure, the nation could never have achieved the rate of growth it did in even double the time it took. The Party's decisions were also very well thought out for the reason suggested in Part 1 – the vast investments that were made were coordinated and integrated, not new roads to nowhere but roads to somewhere, along with new trains, new ports and new cities. All were constructed so as to achieve optimal synergies between these individual investment schemes. The result – optimal economic growth for over three decades, regardless of the absence of democracy that upsets many in the West.

THE THREATS AND OPPORTUNITIES AHEAD

During the past three years, China has experienced a severe slowdown in growth, and the IMF now predicts average growth of 6% between 2015 and 2020, way down from about 10% in the decade preceding 2015. Many observers, especially pessimists, argue that this slowdown will accelerate and that double-digit growth will rarely be seen again.

Four widely acknowledged sources of pessimism

Supporting such pessimism are fears that (i) today's debt crisis will accelerate; (ii) the housing and real estate bubble will burst; (iii) adverse demographic trends will exacerbate today's slowdown long-term; and, (iv) the ability to relocate large numbers of unproductive workers from farms to the cities is nearly over.

These threats are discussed daily in the opinion pages. And each can play a role in further slowing growth in the months and years ahead. However, as will be seen below, each of these threats can be mitigated by appropriate government policies. Hence these threats need not derail China from emerging as the supreme economic power on earth, assuming that proper policies are adopted.

The true sources of pessimism

China confronts a set of much deeper challenges that could derail long-run growth. If these challenges are not confronted and dealt with, not only will growth be suboptimal, but grave political crises could proliferate. The preconditions for a rapid transition from Stage 3 to Stage 5 growth include:

1. an end of crony capitalism and systemic corruption;
2. the advent of the rule of law directed by a non-corrupt judiciary;
3. the institution of private property rights;
4. the establishment of human rights and civil liberties; and,
5. substitution of a bottom–up in place of a top-down resource allocation system.

Satisfying these five preconditions is logically required for an emerging economy to transform itself into one based upon mass consumption, and to do so rapidly.

Let's consider a case study – where does China stand at present in confronting the first of these five challenges, namely eliminating crony capitalism and systemic corruption? This case study will shed light upon the difficulties of overcoming the other four challenges.

Eliminating systemic corruption, and Lord Acton’s Dictum

This challenge is particularly daunting and is unlikely to be successfully confronted because of the sacrifices it requires from those in charge of carrying out reform. We recall Lord Acton's dictum, "All power corrupts; and absolute power corrupts absolutely." The more the new Chinese leadership arrests dissidents, eliminates dissent, eliminates rivals, and consolidates Party control, the more powerful the Party becomes. In carrying out his current anti-corruption campaign, President Xi has admitted that a consolidation of power within the party is one of his principal goals.

Note the contradiction here – as Lord Acton pointed out, the greater the power of those in charge, then the greater corruption will inevitably be. Thus, a commitment to strengthen the party by eliminating corruption is a contradiction in terms. In this regard, the China expert James Leung has written that "the anti-corruption fight is only one part of President Xi's larger push to consolidate his authority by establishing himself as the paramount leader within a tightly centralised political system."

What are the deeper causes of corruption in China? Leung writes[2]

> The main culprits are one-party rule and state control of the economy. The lack of firm checks and balances in a one-party state fuels the spread of graft and bribery; today, no Chinese institution is free of them. And state control of resources, land, and businesses creates plenty of opportunities for corruption... According to Chinese statistics, the private sector now nominally accounts for around two-thirds of China's GDP and employs more than 70% of the labor force... Nevertheless, the private sector is highly dependent on the government, which not only possesses tremendous resources, but also uses its regulatory and executive power to influence and often control private businesses... The immense regulatory power that Chinese authorities hold over the private sector also helps them line their own pockets.
>
> When it comes to government purchasing and contracting and the sale of Chinese state assets (including land), bidding and auctioning processes are extremely opaque. Officials, bureaucrats, and party cadres exploit that lack of transparency... Such arrangements allow corruption to distort not just markets but also the workings of the party and the state.
>
> Similar problems also exist in China's military. To win promotions, junior military officers routinely bribe higher-ranking ones with gifts of cash and luxury goods... In the criminal system, criminal suspects or their relatives often bribe police officers to win release from jail or to avoid prosecution.

Leung also discusses the significant role of State Owned Enterprises (SOEs) in breeding corruption, and in distorting the efficient allocation of resources via the extensive non-marketbased subsidies awarded such enterprises.

The extent of corruption and the nature of its causes augur poorly for a rapid transition of China to a Stage 5, bottom-up, mass-consumption economy. Corruption distorts the incentive structure in ways that not only slow the rate of business formation, and thus growth. It also generates inefficiencies throughout the economy, which also reduce growth. By reading between the lines above, it should be clear how difficult it will be for China to develop meaningful property rights, the Rule of Law, and a truly decentralised (bottom-up) resource allocation system.

An excellent discussion of these and related issues can be found in the articles by Youwei, Hu Angang, Zhiwu Chen, and Baozhen Luo appearing in the special May/June issue of *Foreign Affairs*. The theme running throughout these essays is that the array of Chinese "reforms" now so widely touted are skin deep, and that the pace of reform has slowed significantly with the ascension of President Xi in 2012.

From our standpoint, these developments augur grave difficulties for a successful Chinese transition to a Stage 5, bottom-up, mass consumption driven economy. This is another way of saying that future Chinese growth will be lower than the consensus forecast.

OTHER, MEDIUM-TERM THREATS TO FUTURE GROWTH

Let us conclude by briefly reviewing those more topical threats to growth that most commentators focus upon.

1. Debt Problems

China's total debt in 2007 counting that of private households, independent firms, and government institutions equaled 158% of GDP. In 2014, it reached 282%, the highest in the world for a major economy. With its extensive reserves and rapid growth rate, the Chinese government could deal with such debt, even if doing so required non-disclosed bailouts and local deal-making that violated all norms of transparency. However, with growth having slowed to the "new normal" that President Xi refers to, coping with such debt becomes increasingly difficult. More and more firms, regional banks and government agencies will be forced into liquidation, and many lines of credit will be turned off.

As the *Financial Times* columnist Martin Wolf has perceptively pointed out, if high levels of debt are problematic when growth is good, they become extremely problematic when growth is slow. He likens the situation to riding a bicycle – when you are going fast, it is easy to ride. But when you slow down, the bike begins to wobble, and it can end up falling over.

Our point in this paper is that debt difficulties will cause growth to be even lower than it otherwise would be. Nonetheless, the government may prove to be highly adept at dealing with debt, as it has been in the past, and with some luck, should be able to stabilise the nation's debt/GDP ratio at a level appropriate to a future growth rate of around 4% or 5%.

The bicycle need not fall over in the longer run. However, China will only be able to achieve a stable debt level in the longer run if the nation rationalises its resource allocation system in the manner described above. If political favoritism and SOEs continue to pervert the allocation of capital as in the past, then growing debt could prove catastrophic to growth.

As regards China's short-term debt, there have been widely divergent estimates of the extent of the debt problem. Confusion ended on 15 May when the Chinese government shocked analysts with an admission of how serious the problem is – and with a set of unprecedented policies to deal with it. The *Financial Times* headline of 16 May read "China orders banks to keep lending to insolvent provincial banks!" The authorities explicitly banned financial institutions from cutting off or delaying funding to any local government project started before the end of last year.

Is this an ingenious way in which to prevent debt collapse and soaring unemployment? Or is it an admission of a crisis far greater than had been recognised before May 15?

2. Land and the Housing Bubble

China's debt crisis cannot be discussed independently of the issue of land – who owns it, how it is financed, and why it is so bubble prone. Perhaps the most important issue here is that Chinese debt of all forms is backed by land value. The government (as well as the people) welcomes rising house and land values because they have made possible that massive expansion of credit needed to finance China's rapid rate of growth. The flip side of this is, of course, that a collapse or even a decline in values will cause a larger and more damaging restriction of credit than would be the case in other nations. This in turn implies a more rapid decline in economic growth than would otherwise occur.

What complicates the land values/debt crisis in China are the differing postures assumed by the central government on the one hand, and local governments on the other. This point is stressed by Zhiwu Chen in his article "China's Dangerous Debt" appearing in the 2015 *Foreign Affairs* issue cited above. To quote him:

> In theory, the Chinese state owns all urban land, whereas peasant collectives control agricultural land. In practice, the collectives have little say at all. Only local governments can open up agricultural plots to development, giving them monopolies over the supply of land. Taxes and fees included, the proceeds from such land sales have made up an increasing share of local budgets, accounting for some 46% of (local government) revenues in 2013.
>
> Yet most of the cash has come from loans that local governments have secured through shell companies, or so-called "local government financing vehicles" (LGFVs) using public land as collateral. It is such funds that have, since 1998, made possible the

> country's feverish construction of highways, high-speed railways, airports, subways, steel foundries, office parks, etc.
>
> This reliance on land-backed debt has meant that, despite the central government's recent efforts to stabilise housing prices and avoid a damaging real estate recession, local governments have had a vested interest in keeping house (and thus land) prices high since doing so has allowed them to secure larger loans...
>
> Since Chinese law forbids local governments from borrowing directly, most such governments transferred land titles to LGFVs which could take out loans freely. These bodies have been so successful at circumventing Beijing's prohibitions against local government borrowing – on paper they look like other SOEs – that nobody, not even the Ministry of Finance, knows how much local governments owe. This ambiguity has made it impossible to estimate China's true government debt, although guesses place this between $5 and $7 trillion.

Does this state of affairs suggest a massive real estate price collapse, in tandem with a corresponding credit collapse? Not necessarily. There are two conflicting considerations here.

First, given that the central government owns all the major banks, disaster can be avoided assuming that Beijing continues to be able and willing to bail these out with its plentiful reserves. This is bullish. Second, and more bearish, the central authorities until now have kept their distance from most of the local banks. They have left debt resolution problems of local banks up to the regional and municipal governments. But with the new policies of 15 May, this may be changing.

Since local governments lack Beijing's cash reserves, they have relied upon mediation – bringing together lenders, borrowers, and third-party corporations capable of funding bailouts. But as Chen points out "using land as an instrument to resolve (local) bad debts was only tenable so long as real estate prices remained high and land deals remained attractive – and that is no longer appearing to be the case."

All in all, the debt resolution issue is up for grabs. The central government is walking a tight rope in sponsoring bailouts when necessary, while reducing the huge amount of (bad) credit outstanding.

3. Demographic problems

It is currently fashionable to assert that "demography is destiny". In fact, it isn't. Neither in the West nor in China.

The commonplace mistake in this regard stems from equating slower workforce growth (which reduces growth by definition) with an aging population. The two are very different. If health expectancy soars as it has and will, and if life expectancy also soars as it has and will, the lengthier lifelong participation of workers in the workforce can more than compensate for the fact that we all have fewer children than before. If we add in (i) a greater participation of women in the workforce (Japan's way out), and (ii) the possibility of greater immigration, then fears of contracting workforces are misplaced. Everywhere.

Another mistake comes from the belief that older workers are less productive than younger ones. Recent NBER research suggests that this is not the case at all.

A third mistake is to fail to understand that it is productivity growth and not workforce growth that matters most – the former permits all citizens to enjoy higher living standards, regardless of whether the population as a whole increases or shrinks. In other words, what matters morally is whether per capita GDP rises, and this is driven by productivity growth, not workforce growth.

Now in China, it is true that over the next thirty-five years, China's median age will increase from 35 today to, perhaps, 48. It is also true that the share of people over age 60 is now 16%, and this will roughly double by 2050. The fear is that, as GDP growth slows due to these realities, the government will not be able to afford to provide for the elderly, who will become a financial burden.

Yet as Baozhen Luo points out in his article "China Will Get Rich before it Grows Old" (*Foreign Affairs*, May 2015), a closer look reveals a more positive outlook:

> For one thing, although China's working-age population has been shrinking, its employment rate has been increasing, as has the productivity of those entering the workforce. For another, since around 2000, the Chinese government has aggressively prioritised the creation and expansion of public welfare programs to support the elderly.

There is a quite different concern stemming from demographic considerations. This is the fear that a shrinking work force will raise average wage levels, thus making China less competitive in labor-intensive export industries than other emerging economies including India, Indonesia and Vietnam. But as Luo points out, the truth here is more optimistic:

> Although China's working-age population has indeed shrunk, its employment rate has increased. In 2014, China's active workforce consisted of 772.5 million people, 2.8 million more than in 2013. This growth, despite a smaller working-age population, suggests that many underemployed Chinese, especially in rural areas, are being drawn into the work-force. As Beijing enacts policies to encourage internal migration, including revising the registration

system and increasing investment in the mechanisation of agriculture, more and more surplus unskilled laborers from rural areas will be absorbed into urban manufacturing and service industries.

Luo disagrees with those who claim that China is running outof rural workers to add to more productive urban areas, a view currently made fashionable by a series of recent reports in the *Financial Times*. We cannot judge who is more correct here, although Luo's analysis seems deeper to us.

Finally, Luo points out that a larger portion of the elderly population is staying in the workforce longer than before. This is consistent with the point above about increasing health and life expectancy leading to deferred retirement ages.

To sum up, China does indeed face a serious challenge due to a rapidly aging population. Nonetheless, as with the debt problem, disaster can be avoided if proper policies are adopted.

WHAT IS NEW IN OUR ANALYSIS

This concludes our survey of China's challenges and opportunities. What is new in this paper is our emphasis on the importance of a new incentive structure throughout Chinese society that will make possible a rapid transition to a Stage 5 mass consumption society. Without the Rule of Law, sanctity of contracts, a decentralised resource allocation system, and an end to rampant corruption, China will not become a Stage 5 political economy anytime soon. As a result, the growth of GDP will slow considerably. This is because, in the fifth stage of the evolution of an emerging market, growth is propelled bottom-up by millions of individuals who are willing to take risks, and to make deals with others whom they can trust.

These deals will not be made in a thugocracy. We give odds of only 20% that China will make such a transition, one requiring the Communist Party to give up most of its control. As a result, we expect China's growth to be considerably lower than "the new normal" 6% now forecast. And this conclusion is independent of the denouement of the debt and/or demographic crises which most other observers believe to be the true problems confronting China's future.

ENDNOTES

1. A foundational reference here is "Optimality and Informational Efficiency in Resource Allocation Processes" by Leonid Hurwicz, appearing in *Mathematical Methods in the Social Sciences*, Ed. K.J. Arrow, P. Suppes, and S. Karlin, Stnford University Press, 1959.
2. See “Xi’s Corruption Crackdown,” by James Leung (political pseudonym), *Foreign Affairs*, May/June 2015.

Dr Horace "Woody" Brock is President of Strategic Economic Decisions, Inc., a renowned economic think tank. Dr Brock has spent more than 25 years counseling global corporations, governments and institutions who benefit from his in-depth analysis of ongoing structural changes in the global economy. He is author of American Gridlock - Why the Right and Left Are Both Wrong, Commonsense 101 Solutions to the Economic Crises. More than 50 leading chief executives, academics, journalists and investors endorsed the book, published in January 2012 by John Wiley & Sons, Inc.

Woody is a regular Faculty member at PortfolioConstruction Forum programs. This article is abridged and reproduced with permission.
