

Is China's Economic Growth Sustainable?

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High-school students in Shanghai were surprised to learn that Mao Zedong, the venerated statesman whose teachings once anchored China's social sciences curricula, now elicits a solitary mention in their textbooks.¹ The Chinese government maintains that this shift owes far less to a diminished respect for Mao than it does to a growing recognition of the country's promise: It wants to steep the country's youth in the virtues of capitalism and the promise of globalization – and not without proper reason. For the past two-and-a-half decades, China has sustained an annual growth rate of nine to ten percent, a record of achievement that even the most skeptical of observers concede to be remarkable. By virtue of its immense population and its economic ascendance (it now stands as the world's fourth largest economic power), its development path quite literally entails global consequences.

Because China is of such central importance, I find the character of contemporary discourse on China's rise to be so worrisome. While many analysts view China as the world's next economic superpower, surprisingly few consider (with much concern, anyway) two central obstacles to its growth: increasing income inequality and a weak innovative capacity.²⁽ⁱ⁾ *I argue herein that, largely owing to these phenomena, China is unlikely to be able to sustain its current pace of growth.* Given this premise, it is fitting that I structure the remainder of my essay around a discussion (or criticism thereof) of Simon Kuznets' influential 1955 postulation. At the risk of oversimplifying his conclusion, Kuznets argued that developing economies would experience rising income inequality as they industrialized, but declining income inequality as they oriented toward higher-productivity sectors.³ He seemed to view inequality merely in transitional terms: That is to say, he (1) appears to have regarded it as a necessary prerequisite to stable growth, not as a problem unto itself. He (2) further appears to have presumed that developing economies would have in place a functional, robust innovative apparatus at the time of their transition to industrialization. In China, however, these twin assumptions are highly tendentious.

If one accepts the supposition, as seems reasonable, that developed economies have achieved sustainable growth on the shoulders of their middle classes, one must conclude that China's prospects are presently unfavorable. As of 2005, less than 5% of its population belonged to the middle class (that is, belonged to a household whose income is at least \$10,000 per year).⁴ While countries can achieve, and often have attained, impressive rates of economic growth without a thriving middle class, none have been able to sustain this fractured development.⁽ⁱⁱ⁾ Indeed, as *National Geographic* notes in a poignant survey of Manchuria, the beacon of Maoist China that now faces decline, China is home to a complex network of divides: "China's growing wealth gap is usually seen as a divide between urban and rural, east and west, but is also cleaves north and south." Unfortunately, government officials have heretofore espoused a policy of pragmatism over principle: That is to say, income inequality, no matter its degree or scope, must be accepted as a condition of economic growth.

(i) One common measure of income inequality is the Gini coefficient (GC), which is a ratio between zero and one. If each quintile of a given country's population possessed 20% of its income, that country's would be zero. As the fraction of income that a given country's top quintile possesses increases, so does that country's GC. The meaning of the term "innovative capacity" is reasonably self-evident. A country with a high innovative capacity is one whose institutions – educational, economic, legal, and so forth – allow it to dynamically and continually generate new products and services in a myriad of sectors.

(ii) For a thorough treatment of this point, see Kevin Phillips, *Boiling Point: Democrats, Republicans, and the Decline of Middle-Class Prosperity* (New York: Random House, 1993). For a helpful summary of Phillips' text, see Frank J. Sorauf, "Boiling Point: A Review," *Political Science Quarterly*, Vol. 109, No. 2 (1994) pp. 367-38.

The deficiencies of this prescription are increasingly manifest. Indeed, far from possessing an auto-catalytic character, as some analysts would suggest, China's economic growth operates under a myriad of constraints. In their second annual "Failed States Index," which tracks 12 indicators to assess countries' vulnerability to internal upheaval, the Fund for Peace and the Carnegie Endowment for International Peace ranked China 57th out of 146 countries (a lower rank signifying greater risk). Noting growing peasant unrest over land expropriation and continuing unemployment, the survey observed that "Party officials must find new ways to mollify the masses while keeping the country's economic engine in high gear."⁷ The predictable rejoinder to this argument is that unrest and dislocation are inevitable concomitants of economic growth. In a compelling piece that appeared in *The Financial Times*, Victor Mallet analogized China's present phase of industrialization to Great Britain's in the 19th century.⁸ This comparison comes under duress, however, when one notes that China is home to one-sixth of humanity. Indeed, with 160 million Chinese living under \$1 per day, and 486 million living under \$2 per day, the government's failure to address income inequality could sow internal chaos on a mammoth scale. It is important, then, not to disassociate economic growth from its political consequences (and, if I had the space in which to discuss them, its social and environmental ones). The latter can critically constrain, or even reverse, the former.⁽ⁱⁱⁱ⁾

Even if one believes that establishing the aforementioned dichotomy – economic and political – is not problematic, one would yet find it difficult to argue that China's economic prospects are assured. For the past three decades, China has prospered largely on the back of one sector: manufacturing. By virtue of its size, it was able to accrue nearly continual economies of significant scale by establishing industrial parks and conditioning its workers to achieve maximum efficiency. In 2005, manufacturing accounted for over half of China's economic growth and manufactured goods accounted for 91% of its exports.⁹ Now, however, for the first time in its history, foreign direct investment (FDI) in its manufacturing sector has declined; that is to say, the sector that has all but anchored China's expansion is no longer a guarantor of its long-term success.¹⁰ In light of this outcome, Beijing is suddenly stressing the importance of innovation. In February 2006, for example, the Chinese government announced a "National Medium- and Long-Term Programme for Scientific and Technological Development (2006-20)."¹¹ Its ability to innovate, in turn, depends on (1) the global competitive posture of its firms and (2) the quality of its labor force.

Especially since China's accession to the World Trade Organization in 2001, sustained inflows of FDI have largely obviated the need for its companies to be competitive. Now, however, multinational corporations are reconsidering the wisdom of investing in China as the weaknesses of its domestic industry are becoming more apparent. In particular, the difficulties that its manufacturing companies have experienced in completing and sustaining overseas acquisitions attest to their inexperience and lack of exposure to global markets. TCL Corporation and Lenovo Group, two of China's well-known manufacturing firms, have suffered in large part because they have relied "on the brands' [RCA/Thomson's and International Business Machines', respectively] existing global distribution networks," rather than developing their own.¹² Cognizant of these and other such developments, government officials are beginning to stifle FDI, in the hopes that homegrown companies will be able to hone their savvy and knowledge in a more protected atmosphere. If, contrary to their assurances, this move is not temporary, but part of a broader strategy, multinationals may lose their patience and turn elsewhere. A withdrawal of FDI would likely have serious consequences for China's economy, considering that the role of foreign-funded companies (FFCs) therein has steadily grown. In 2001, FFCs accounted for approximately 50% of Chinese exports; by 2005, that figure had risen to about 60%.¹³

The success of homegrown companies rests in equal measure on the vision of their strategic management and the competence of their laborers. While China indeed possesses a vast pool of workers, few of them are able to compete in today's global economy. According to a report of the McKinsey Global Institute, in fact, only 10% of its engineers possess the required training and skills to perform competently in entry-level jobs.¹⁴ Because China has relied on manufacturing to propel its growth for so long, its educational institutions have cultivated an atmosphere in which theoretical discussions are emphasized far more than practical applications. It is only by reversing this focus that it will be able to succeed as a global innovator. Of course, China must overcome serious challenges before it can achieve a shift of this nature and depth. At the most fundamental level, it has to ensure that students will be able to afford an education (whatever its quality) at a time when market forces are privatizing China's educational apparatus. For the past two decades, the proportion of government spending on education has declined, such that China now spends only 3.2% of its output on education – a figure that places it behind not only most developed economies, but also many of its Asian neighbors.¹⁵ If one objectively appraises the above reasoning, one concludes that China's ability to

(iii) One of the potential harbingers of widespread dissatisfaction is an underperforming labor force. At present, disappointed with poor working conditions and lacking incentives to stay put, Chinese workers increasingly engage in "job hopping," such that employers struggle to retain and, in many cases, merely find, workers. The term "job hopping" is taken from Andrew Ross, *Fast Boat to China: Corporate Flight and the Consequences of Free Trade; Lessons from Shanghai* (New York: Pantheon, 2006). The consequences of this paradoxical phenomenon – paradoxical, because the probability of its manifesting would seem to be lowest in the world's most populous country – are significant. A prominent business magazine issued the following assessment: "[China's] No. 1 challenge today is finding and keeping good workers. Turnover in some low-tech industries approaches 50%...Reports of labor shortages first cropped up in late 2004, but companies thought the phenomenon was temporary. Now a surge in both turnover and wage costs is convincing multinationals and their suppliers that the China game is changing permanently." This quote is taken from "How Rising Wages Are Changing the Game in China," *BusinessWeek* Online, available at <http://www.businessweek.com/magazine/content/06_13/b3977049.htm> (March 27, 2006).

innovate is conditioned on implementing critical structural and societal reforms. In turn, if one accepts Robert Solow's argument that long-term economic growth is ultimately a function of exogenous technological innovation, rather than endogenous determinants, one becomes further convinced that China's economy has reached a most critical, uncertain juncture.

In this paper, I have not addressed China's panoply of other internal issues: systemic government corruption, severe environmental degradation, a rapidly aging population (one that is, in fact, growing faster than any other in recorded human history), and an incipient AIDS epidemic are but a few of these other concerns. Even if one entertains the fanciful notion that these problems are of trivial concern, and examines China's economic trajectory as though it operated independently of them, could one reasonably suggest that China does not face momentous obstacles? Without a strong middle class and a robust innovative infrastructure – in short, two fundamentals whose absence all but precludes sustainable growth – China is constrained to one of two paths. (1) In the case that it works proactively to develop each of these building blocks, it will necessarily have to compromise rapid growth through the foreseeable future. (2) If it opts to maintain its current strategy, political crisis may well envelop the government, thereby effecting a reversal in China's economic growth. In the environment that presently characterizes mainstream debate over its expansion, one can only hope that these scenarios elicit the attention that they deserve. It is no exaggeration to suggest that China's future and, to an extent, that of the world, will depend on such analysis.

Endnotes

¹ Joseph Kahn, "Where's Mao? Chinese Revise History Books," *The New York Times* (September 1, 2006) p. A1.

² I find it surprising that such a provocative proposition — namely, that China is poised to supplant the United States as the world's economic superpower — so rarely goes challenged. In business literature, in particular, it has become something of a gospel. For an influential elucidation of this view, see Ted C. Fishman, *China, Inc.: How The Rise of the Next Superpower Challenges America* (New York: Scribner, 2006).

³ Thomas Piketty, "The Kuznets Curve: Yesterday and Tomorrow," in Abhijit Vinayak Banerjee et al. (eds.), *Understanding Poverty* (New York: Oxford UP, 2006) p. 63.

⁴ Lyric Hughes Hale, "It's a Juggernaut...Not!," *Los Angeles Times* (May 22, 2005) p. M1.

⁵ Brook Larmer, "Manchurian Mandate," *National Geographic* (September 2006) 63-66.

⁶ There is a belated recognition among government officials that their present policy is not sustainable. See Edward Cody, "China Promises Equitable Growth," *The Washington Post* (October 1, 2005) A12.

⁷ "The Failed States Index," *Foreign Policy* (May / June 2006) p. 53-54.

⁸ Victor Mallet, "Welcome to Megacity," *Financial Times Weekend* (August 5-6) p. W1.

⁹ The figure on GDP share comes from Allan Seychuk, RBC Financial Group, "India – Another China in the making?," *Current Analysis*, available at <www.rbc.com/economics/market/pdf/india.pdf> (February 2005) p. 5. The figure on exports comes from Ira Kalish, Deloitte Research, "China and India: The Reality Beyond the Hype," available at <www.deloitte.com/dtt/cda/doc/content/US_ChinaIndiaReality_Research.pdf> (2006) p. 2.

¹⁰ Andrew Batson, "China Loses Some Allure as a Manufacturing Hub," *The Wall Street Journal* (August 7, 2006) p. A4.

¹¹ "Something new; Getting serious about innovation," *The Economist* (August 5, 2006) p. 38-39.

¹² Gary McWilliams and Evan Ramstad, "China's Aggressive Buyers Suffer Setbacks on Some Overseas Deals," *The Wall Street Journal* (August 22, 2006) p. A1.

¹³ Andrew Batson and Mei Fong, "In Strategic Shift, China Hits Foreign Investors With New Hurdles," *The Wall Street Journal* (August 30, 2006) p. A1.

¹⁴ Gary Gereffi and Vivek Wadhwa, "Framing the Engineering Outsourcing Debate: Placing the United States on a Level Playing Field with China and India," available at <http://memp.pratt.duke.edu/downloads/duke_outsourcing_2005.pdf> (December 12, 2005) p. 9.

¹⁵ David Lague, "In China, learning is a rising burden," *International Herald Tribune* (August 27, 2006) p. 1.

