The Middle Kingdom’s middle-income trap

INTRODUCTION

It is relatively easy for countries, which have a somewhat stable political environment, to climb out of poverty and reach middle-income status. However, history proves that it is much harder for economies to make the transition to a high-income economy (in the absence of abundant natural resource rents). China’s economic rise is now approaching this ‘middle-income trap’ with full speed, but can it avoid it?

OBSERVATIONS

- A famous World Bank study in 2012 showed that of the 101 middle-income economies in 1960, only 13 had become high-income economies by 2008.
- Many countries in Latin America and the Middle East reached a middle-income status in the 1960s and 1970s but remained there ever since, providing evidence for the ‘middle-income trap’. The ‘Four Asian Tigers’ did succeed.
- Following the latest World Bank definition of a middle-income economy, China is approaching the level of GNI per capita ($7,900 in 2015) at which some major economies - such as Brazil, Lebanon, South Africa, Malaysia, and Thailand - have been stuck for decades.
- China is set to lead the next generation of wireless systems, and successfully launched the first 5G test site.
- E-commerce in China grew by about 30% in recent years, m-commerce by more than 70% in 2016.

ANALYSIS

One cause of the middle-income trap is the diminishing returns on capital investments (for other causes, see this overview paper). High investments rates (especially of the public sector) generate economic growth for low-income economies. Indeed, sustained capital accumulation has been a key feature of East Asian countries during their initial stage of development. But as economies develop, both public and private capital accumulation are subject to diminishing marginal returns, especially during stages of extensive growth. This growth slowdown is not so much a result of slowing capital accumulation as such, but of productivity slowdowns of the capital stock. As countries want to avoid the middle-income trap, they should transition from “basic” capital investments - like railways, buildings, and highways - to more "advanced" investments like digital infrastructure, R&D spending, and creating innovative and service-based economies.

Where does China currently stand? From a macro-perspective, it’s useful to compare China to a number of regional middle-income economies (Brazil, South Africa, Thailand, Malaysia, and Lebanon) and high-income economies (the Asian Tigers and the U.S.). In recent years, China has moved closer to these last countries in a number of metrics of advanced capital investments. For example, China has a higher degree of fixed broadband subscriptions than its middle-income peers around the world, which currently even surpass those of most high-income countries. Furthermore, China ramped up R&D spending, and is planning to increase it further to 2.5% of GDP, surpassing the average of OECD members. As a result, China has jumped in the Global Innovation Index to position 22, whereas Brazil, Thailand, Lebanon, and South Africa hover between position 50 and 80. Lastly, China largely outpaces the other middle-income countries regarding the degree of connectedness in the global economy, and therewith finds itself just below most high-income countries. Tese developments seem to correspond with China’s strategic vision of becoming a "modern, harmonious and creative society" by 2030. From a consumer perspective, Chinese are already adapting to a more advanced and digital economy. First of all, Chinese consumers have a high smartphone user penetration rate, which is still increasing rapidly. China already is the leader in m-commerce and Chinese netizens change our ideas about online shopping. Furthermore, its "normal" B2C e-commerce is still growing fastest of all major economies, and is now larger than that of the U.S. and U.K. combined. Lastly, Chinese online shoppers are much more willing to use digital payments methods, and China’s booming fintech industry leads the world in market size. In fact, China’s smartphone integration and online culture are much more advanced those of other "advanced" economies.

Both the transition of Chinese capital investments and the habits and characteristics of China’s consumer economy might help China to avoid getting trapped.

POTENTIAL BENEFICIARIES

- Middle-income countries with the financial capacity to make advanced capital investments.
- Investors capable of making a “Big Push” in China’s advanced infrastructure, due to the lumpy nature of infrastructure investments and non-lineairities in advanced infrastructure benefits (due to significant network effects).
- Producers of “digital oxygen” in China.