

## Chapter 2, Section 1. Towards Avoiding the Middle Income Trap

### (i) Challenges towards China's Transition to Stable Growth

- Although China has maintained high economic growth, there are concerns that China will fall into the middle income trap. (Fig. 1 - 2)
- In order to overcome potential inflection of the rate of investment and make the transition to stable growth, China needs to raise contributions of innovation. While China's total factor productivity (TFP) has been improving steadily, like those of countries with stable growth, capacity utilization is declining in certain industries, including the steel industry, and signs of excess capital investment are observed. (Fig. 3 - 5)

Fig. 1 GDP per Capita and Growth Rate

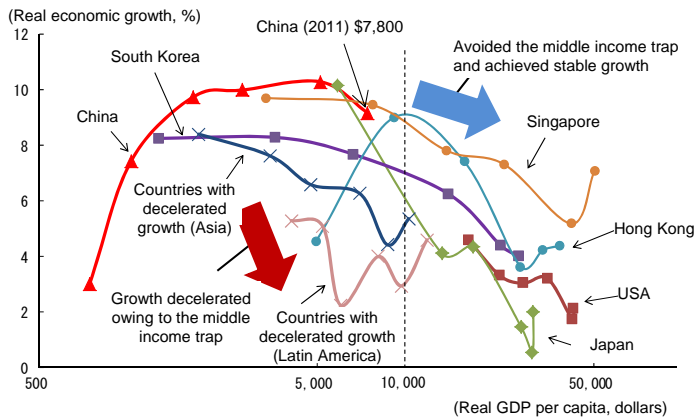


Fig. 2 Growth Rate before and after the Period of High Economic Growth

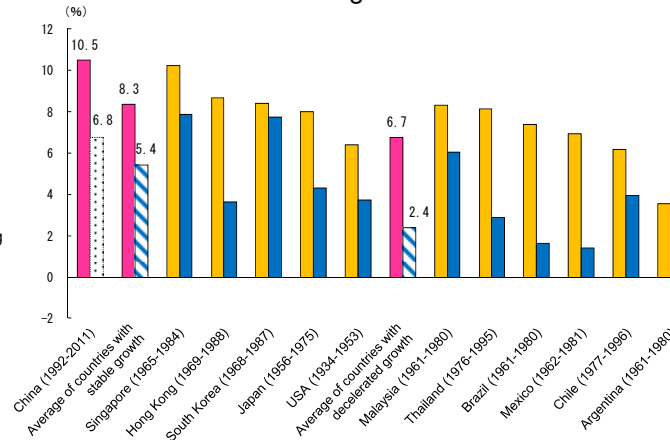


Fig. 3 Trends in the Rate of Investment

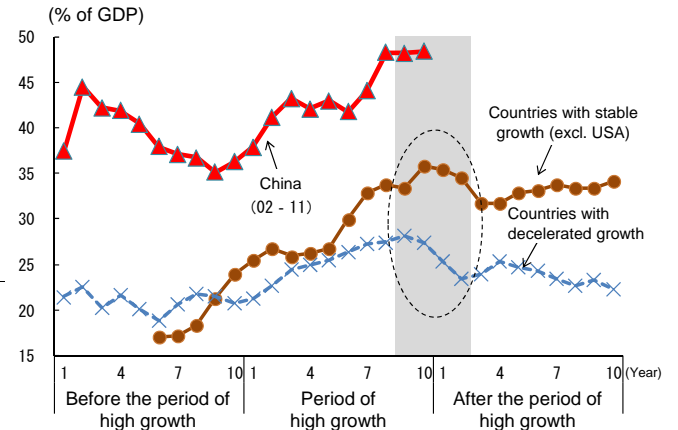


Fig. 4 Trends in TFP

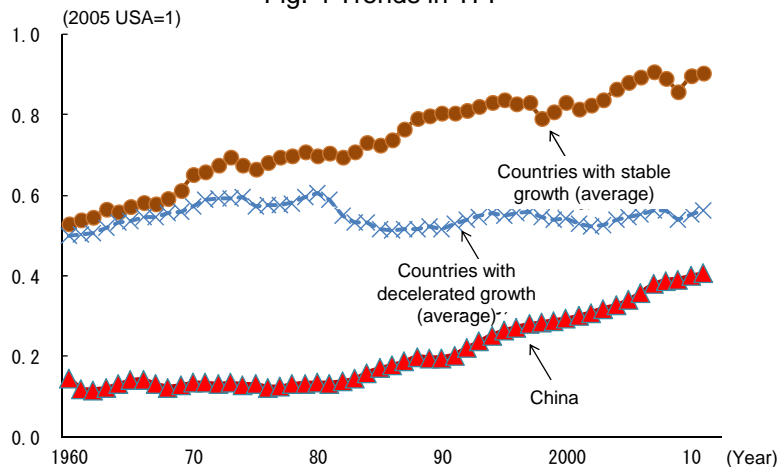
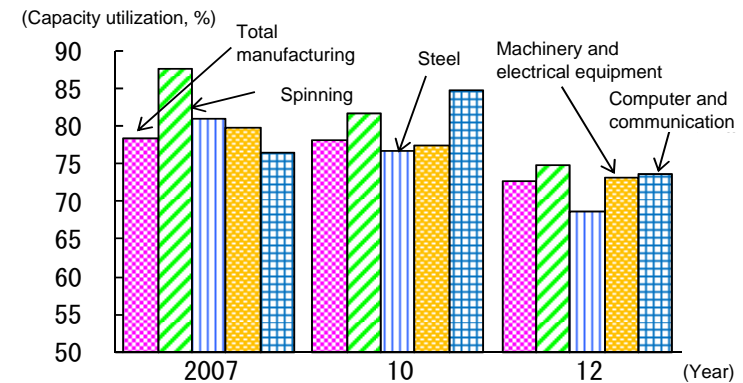


Fig. 5 Trends in Capacity Utilization



## Chapter 2, Section 1. Towards Avoiding the Middle Income Trap (ii) Improvement of Technology Intensity is the Key

- In order to make the transition to stable growth, it is important to improve the technology intensity of exports and industries, while making manufacturing the core. Therefore, the role of inward investments in the manufacturing sector continues to be important. (Fig. 6 - 9)
- Disappearance of demographic dividend, which is indicated as a challenge specific to China, can be a negative factor against growth, but its linkage with the middle income trap is low. (Fig. 10)

Fig. 6 Trends in the Share of the Manufacturing Sector

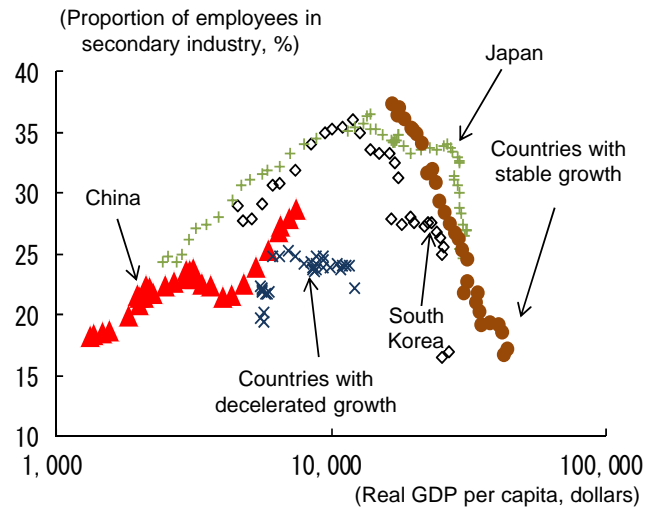


Fig. 7 Export Ratio

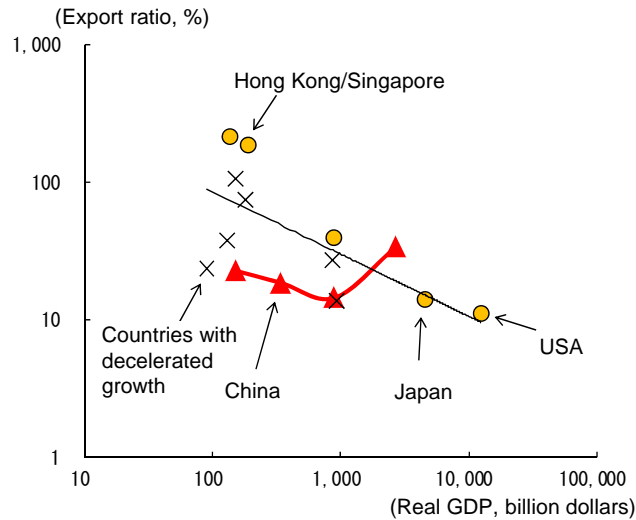


Fig. 8 Direct Investment (% of GDP)

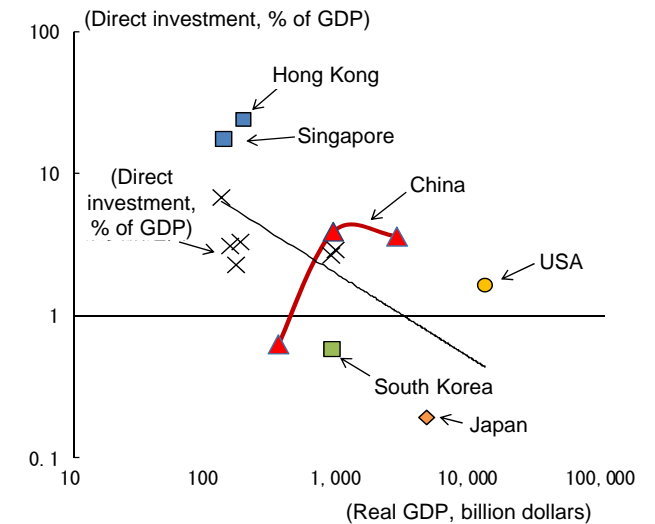


Fig. 9 Share of Export Products with High Comparative Advantage

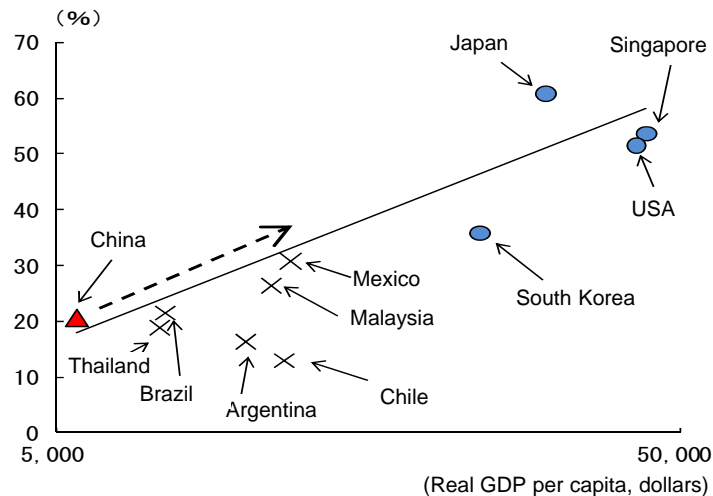
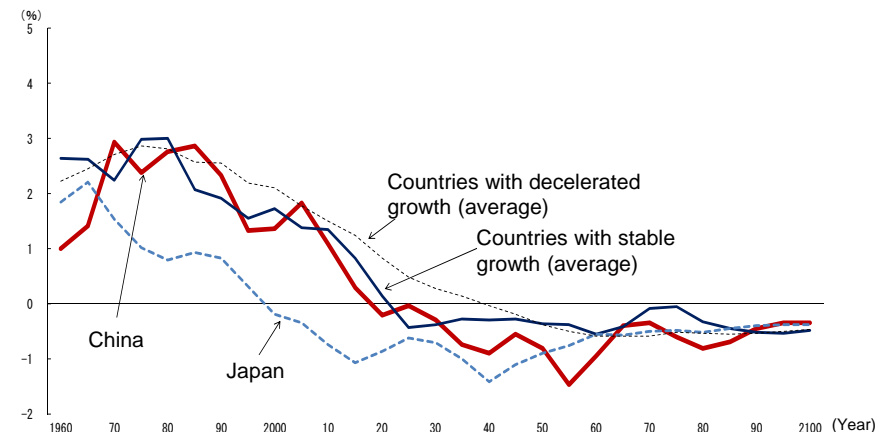


Fig. 10 Growth of Working-Age Population



## Chapter 2, Section 2. Challenges Towards a Soft Landing of the Economy

- As a result of the economic stimulus measures since 2009, operational efficiency of state-owned enterprises (SOEs) has declined owing to excess investment. Housing market indicators, such as property price increases or property prices compared to annual income, exhibit a similar level of overheating as those of other countries during the boom period. There is also a possibility of overheating in property investment driven by local governments. (Fig. 11 - 14)
- China is in the course of liberalization of the financial market. Shadow banking is expanding owing to the weak prudential regulation. China needs to cool the overheated capital market by enhancing prudential regulation (i.e. measures to reinforce financial supervision), apart from adjustments to interest rates, etc. (Fig. 15 - 16)

Fig. 11 Return on Assets of State-Owned Enterprises

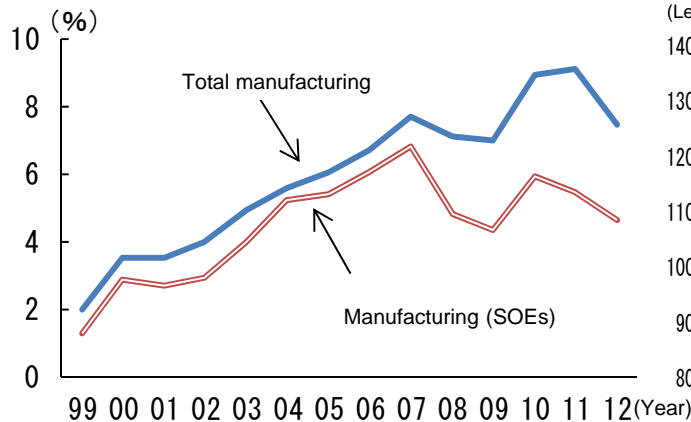


Fig. 12 Property Prices

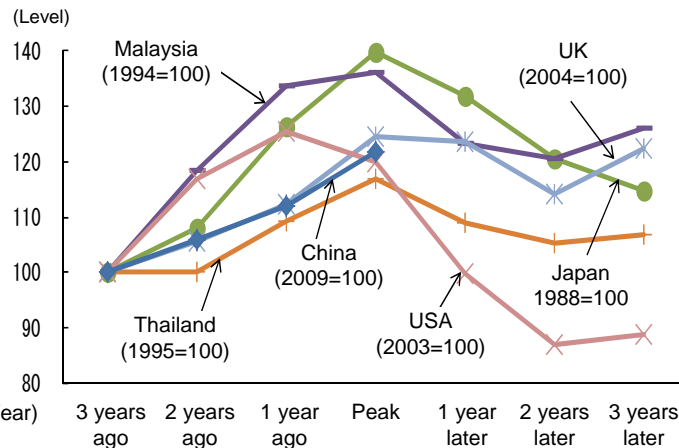


Fig. 13 Property Prices as a % of Annual Income

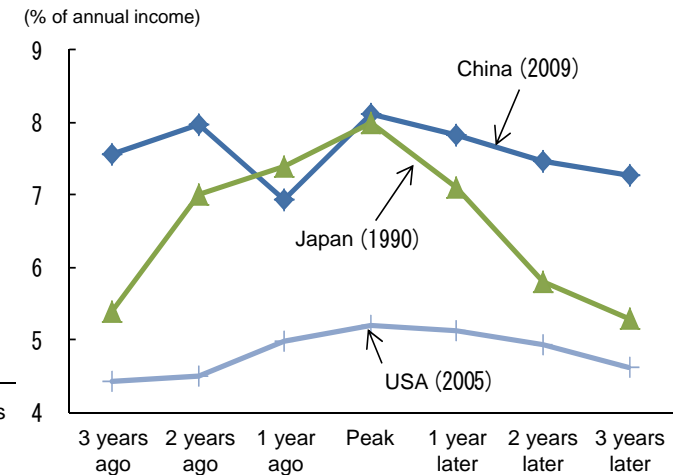


Fig. 14 Revenue Composition of Local Governments

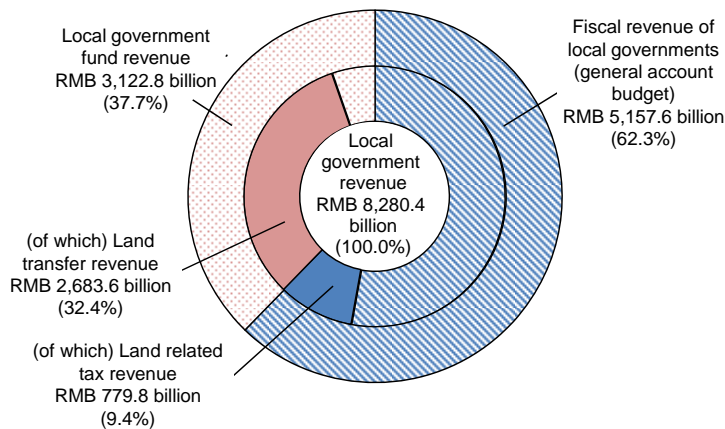


Fig. 15 Indirect and Direct Financing

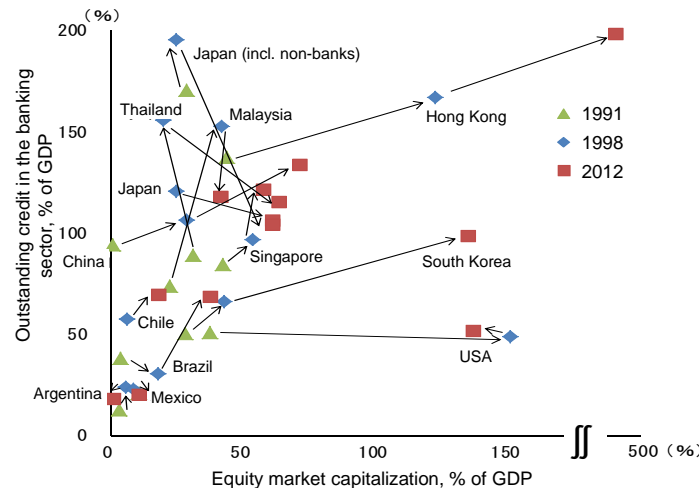
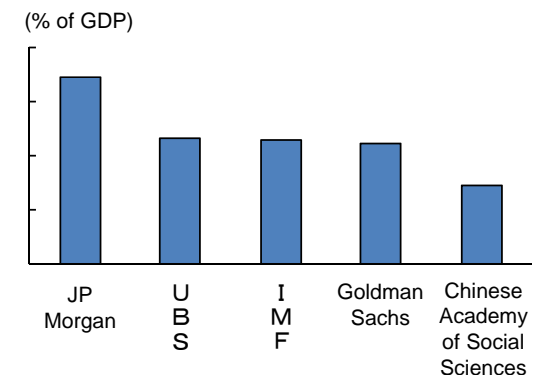


Fig. 16 Size of Shadow Banking



## Chapter 2, Section 3. The Future of the Chinese Economy, and the Global Economy

### (i) The Increasing Presence of China and Its Connection with the World

- China now accounts for 12% of the world economy, with its contribution to world growth in the last five years reaching almost 50%. Its synchronization with the GDP growth of other countries is also trending up. (Fig. 17 - 18)
- China's growth rate in the next 10 years will possibly decelerate to around the mid-6% level, even if China succeeds in avoiding the middle income trap. Growth of the TFP will be the key in the future. (Fig. 19)
- Dependence on China is increasing especially in Asian countries and resource-rich countries, which indicates China's increasing connection with the world through global trade. (Fig. 20)
- China's connection with the world through capital flow is limited, but capital inflow to China is actually increasing gradually. (Fig. 21)

Fig. 17 Contribution of China to the World GDP

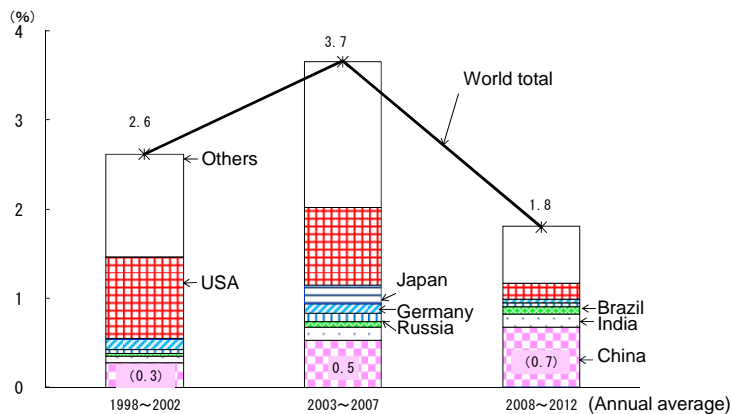


Fig. 19 Future Growth Forecast

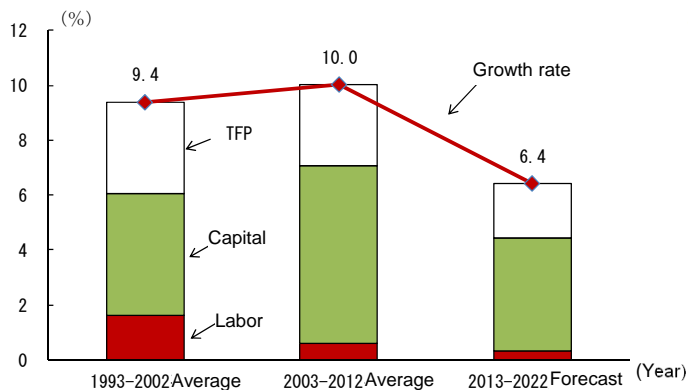
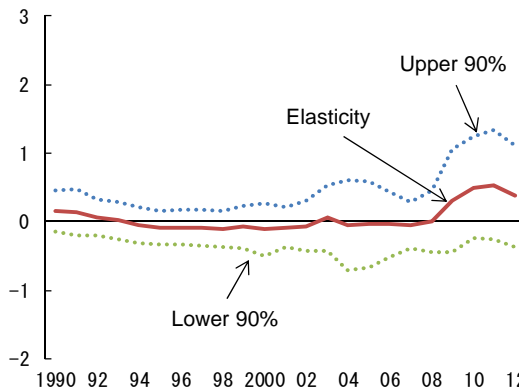


Fig. 18 Correlation between GDP Growth of China and GDP Growth of Other Countries

(1) Major Countries



(2) Resource-rich Countries

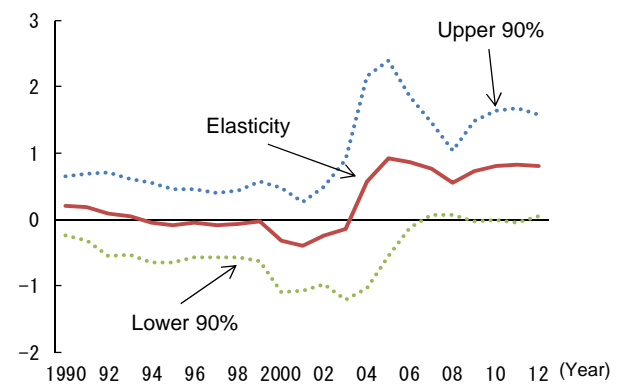


Fig. 20 Share of Exports to China

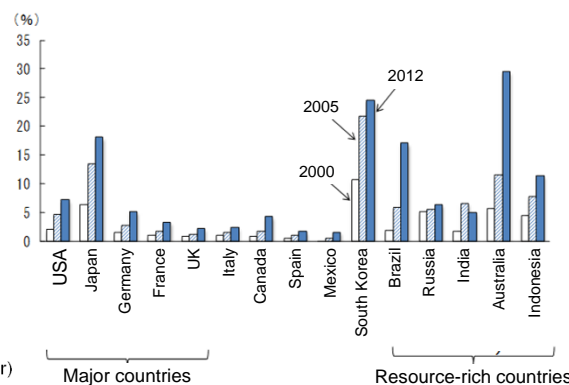
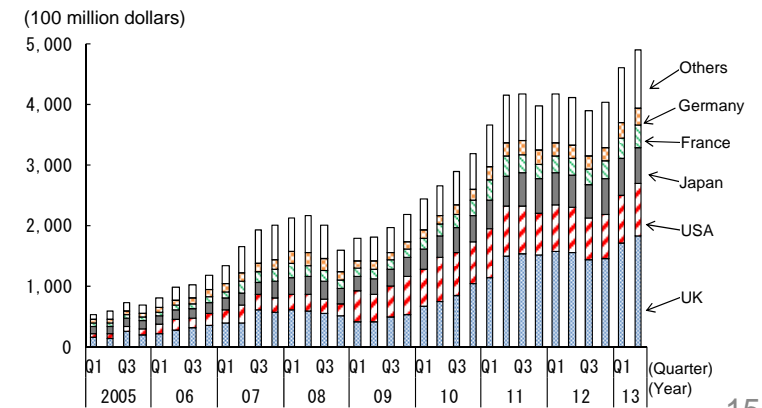


Fig. 21 Credit Balance to China from Banks in Each Country



## Chapter 2, Section 3. The Future of the Chinese Economy, and the Global Economy

### (ii) Upgrade of the Economy and Progress in Transition to a Service-Based Economy

- Discretionary consumer spending is likely to expand as a result of the rise in income levels. Increases in spending on items, including durable goods such as consumer electronics products and automobiles, as well as services, is expected. (Fig. 22 - 23)
- If China improves the technology intensity of export goods, some countries, especially developed countries, will possibly face greater competition with China. (Fig. 24)
- Service trade is an area where international division of work can be expected. Imports of services to China are increasing, and internal direct investment is also rising in service sectors. (Fig. 25 - 26)

Fig. 22 Composition of Household Consumption in China

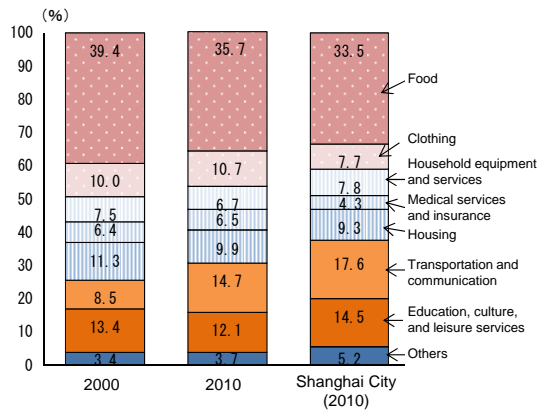


Fig. 23 Percentage of Total Consumption (Leisure)

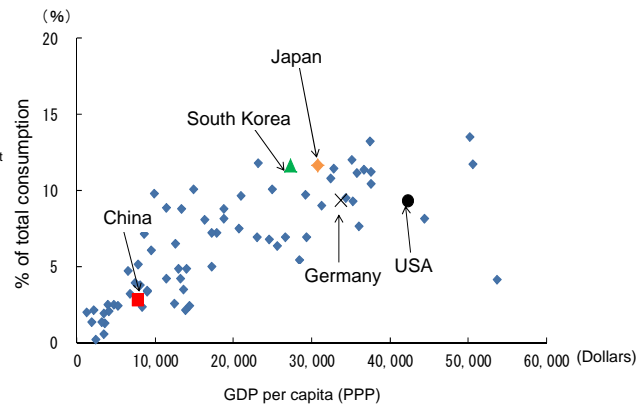


Fig. 24 Trade Correlation Index

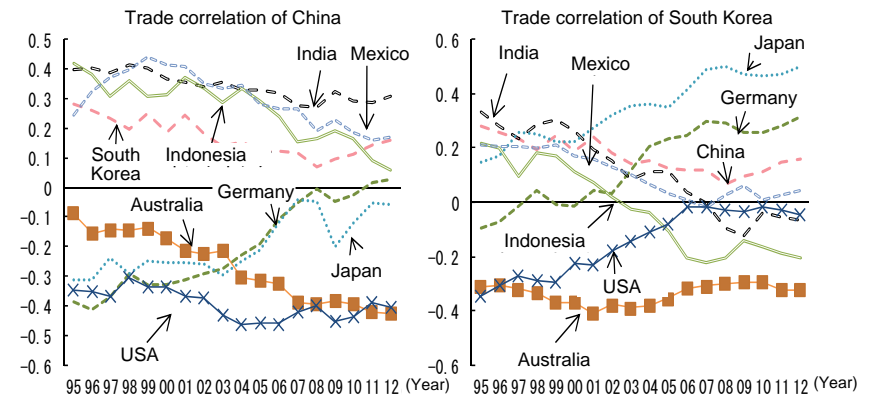


Fig. 25 Trends in Service Trade in China

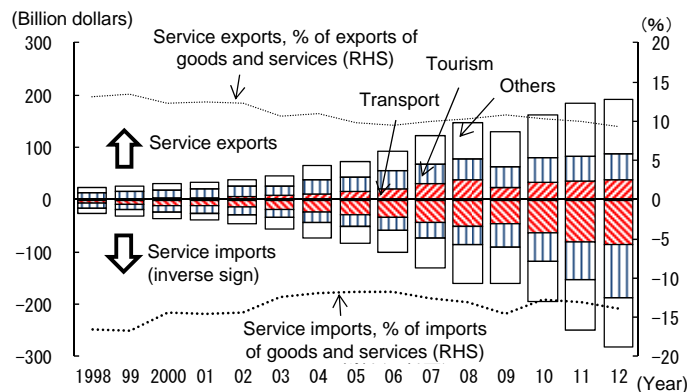
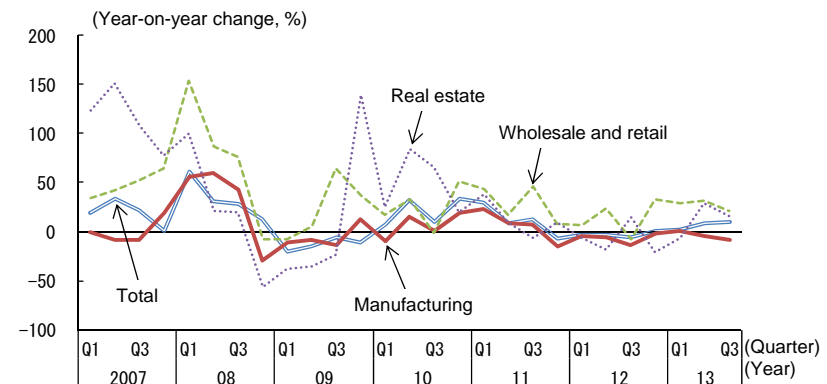


Fig. 26 Trends in Direct Investment



## Chapter 2, Section 4. Conclusion

- The key for avoiding the middle-income trap and making the transition to stable growth is to improve productivity by upgrading exports and maintaining the proportion of the secondary industry. China has similar characteristics in many aspects as those of stable-growth countries in the past, but there are some issues, including a weak domestic consumption and the delay in fostering human capital.
- There is a possibility of over-financing in China, given factors such as the rise in housing prices and the volume of credit supply. The underlying issues include the delay in setting prudent regulations in response to the progress in liberalization, as well as the inappropriate incentive structure. Going forward, China needs to develop regulatory regimes while sequentially promoting policies, including liberalization of the financial market, and China has to navigate this narrow path in order to achieve a soft landing.
- China's growth rate in the next 10 years is likely to decelerate to around the mid-6% level. As a result, Asian countries and resource-rich countries with high dependence on China will possibly be affected mainly through trade. Chinese exports are expected to shift towards high-value-added segments, which will likely lead to intensification of competition especially with developed countries. In the meantime, increases in the consumption of durable consumer goods and services in China could potentially mean the expansion of new markets.