Introduction

With a view towards East Asia as one of the most dynamic regions in the world, the World Bank has published a thematic report series every four years that addresses the region’s unique experiences with development and explores the problems and challenges of particular periods. A report from the 1993 series, entitled *The East Asian Miracle: Economic Growth and Public Policy*, introduced the most outstanding East Asian economies to the world for the first time. Those economies included Hong Kong, Indonesia, Japan, South Korea, Malaysia, Singapore, Taiwan, and Thailand.

While the World Bank report highly valued the economic performance of these East Asian economies, some scholars took issue with such praise. Based on a host of empirical studies, Paul Krugman, the famous economist and columnist, published an essay in the journal *Foreign Affairs* entitled “The Myth of Asia’s Miracle,” questioning the existence of such a miracle as well as the sustainability of economic growth in those East Asian economies.

The outbreak of the East Asian financial crisis in 1997, which seriously derailed most of the East Asian miracle’s performers and exposed their systemic flaws, seemed to prove Krugman’s criticisms true. Of those economies, Indonesia, South Korea, Malaysia, and Thailand suffered the most. Time ultimately seems to have favored the World Bank’s judgment after all, however. After 1998, many of the economies in East Asia once again demonstrated strong economic growth. As of 2007, East Asia as a whole had not only recovered from its deep financial crisis, but also renewed its vigorous economic growth. In response, the World Bank published another thematic report on the region, entitled *The East Asian Renaissance: Ideas for Economic Growth*.

That the World Bank has cheered on the region’s recovery from economic crisis reveals something significant, that is, the return of the region to historical importance. The World Bank demonstrably holds great expectations for the renaissance of an emerging East Asia. According to economic historian Angus Maddison, as late as 1820 the East Asia and Pacific region still produced 40 percent of the world’s gross domestic product (GDP). The latest World Bank report indicates that East Asian economies are once again emerging as leading economic powers.
It’s worth noting that, unlike the 1993 report, which did not focus exclusively on China, the 2007 report had an optimistic conclusion about the region that was almost entirely based on the successful economic growth of China and its contribution to the global economy. Therefore, when the report advanced the concept of the middle-income trap and warned of the challenges in avoiding such a trap, it is of prime relevance to China, specifically.

There are significant differences in the levels of economic development among Asian economies. The temporal sequence of those economies’ development tells a complex story about economic growth and provides experiences and lessons from each individual economy. As an important component of the East Asian miracle, China can learn much from other economies’ experiences and lessons as revealed by economics literature.

The rapid economic growth in China after reforms were initiated in the late 1970s can be characterized as a process that combines the development of a dual economy with system transition. That is, the massive labor migration from agriculture to urban sectors in the coastal areas mobilized by the gradual elimination of institutional barriers deterring labor mobility between rural and urban areas has translated to a comparative advantage for labor-intensive industries through China’s participation in economic globalization.

American economist Lawrence Summers asserts that future historians who write the history of our time will consider China’s rapid economic growth—which has increased living standards more than a hundredfold over the course of an individual’s life span for the first time in human history—along with its significant impact on people across the rest of the world and the global economy to be among our era’s most important events.

Such an assertion, however, is based on the assumption that China will continue to experience economic growth at an annual rate of 7 percent for more than 70 years (the life expectancy of the average Chinese citizen in the early 1980s). As a particular Chinese saying goes, however, a distance of 90 miles is only half of a 100-mile journey. Since this rapid economic growth has been sustained for less than 40 years (since 1978), there is still a long way to go if China is to make such history.

Dual economy development, characterized by an unlimited supply of labor, is considered by many to be an unalterable growth pattern in China. Though some observers have argued for years that a growth pattern characterized by the production and export of labor-intensive manufacturing goods cannot be shared by ordinary workers and low-income households, they still found it difficult to lend credence to the emergence of a labor shortage and the resultant increase in the wages of average workers in
China since 2004. These emerging phenomena, by definition of the inven-
tor of the dual economy theory in development economics, Arthur Lewis, imply that enterprises can no longer hire from the workforce at a con-
stant subsistence wage rate—in other words, the Lewis Turning Point has arrived in China.

Though there are conflicting opinions over whether China has arrived at its Lewis Turning Point or not, it is hardly deniable that the year 2004 represented a threshold, after which a shortage of migrant workers arose throughout the country, the wages of unskilled workers began to con-
stantly increase, labor inputs in agriculture significantly decreased, and the substitution of capital for labor in all sectors began to become widespread. As a result, labor-intensive industries have begun to shift from coastal areas to inland areas in China, as well as to neighboring countries, and thus China’s growth engine is bound to weaken. All those changes indicate a new phase of economic development.

Dual economy development is usually accompanied by a particular phase of demographic transition, at which the statistically large and increasing proportion of the working-age population forms an excessive supply of labor, which results in extremely low marginal productivity of labor in an agrarian economy. Accordingly, the Lewis Turning Point has a great deal to do with the changing phases of demographic transition. Therefore, with the arrival of the Lewis Turning Point, a country will eventually lose its demographic dividend, which is manifested in the shift from an increase to a decline in the working-age population and from a decline to an increase in the population dependence ratio.

Profound, rapid socioeconomic development and its unique population policies have helped China complete its demographic transition within a much shorter period of time than most other countries that have made the transition. This consequently gives China the unique characteristic of growing old before getting rich. In fact, the working-age population—ages 15 to 59—have already stopped growing and, in 2011, began decreasing. In the face of the disappearance of its demographic dividend and the slowdown of its potential GDP growth rate, the Chinese governments, both central and local, intend to make a concentrated effort to maintain an equivalent order of magnitude in terms of growth rate as over the past 30 years—namely, in a growth rate above the country’s decreased potential capability, there would occur various distortions that would make Chinese economic growth far less balanced, coordinated, and sustainable. In the most extreme situation, there would be a risk of falling into stagnation, as happened in Japan after 1990. But in China’s case the consequence would be what is called the middle-income trap.

China’s possible fate of falling into the middle-income trap is also
correlated with the characteristic of growing old before getting rich. Whether or not, and by how much, population factors negatively influence the future potential of economic growth depends profoundly on how China finds new sources of economic growth after its demographic dividend disappears. Any major policy failures will prevent China from finding such new engines for further growth.

With the help of a demographic dividend, China has accelerated its growth convergence over the past 30-plus years. The arrival of the Lewis Turning Point implies that the Chinese economy is nearing completion of the process of dual economy development. Many East Asian economies have experienced a similar transition, though Japan offers a lesson for how a country could stagnate at a high-income stage, while countries such as the Philippines, Malaysia, Indonesia, and some Latin American countries provide object lessons for being stuck in the middle-income trap. Will China continue its economic growth at a reasonable pace in order to become a high-income country, or will it stagnate for a long time at the middle-income stage?

Although the fate of China’s economic growth is not predetermined, it can be predicted based on economic theories, lessons from other countries, and its own experiences. Most importantly, policy options matter a great deal in determining the direction of Chinese economic development over the coming decades. What we have learned so far suggests that continuing system reform that exploits the potential of the supply of production factors and productivity improvement is the only way to sustain the economic growth of China in order to place it among the world’s recognized high-income countries.

Conflicting arguments exist as to whether or not China has passed through the Lewis Turning Point, how long China can enjoy its demographic dividend, what “growing old before getting rich” means to China’s growth, and how the middle-income trap is relevant to China. Those questions cannot be fully answered based solely on knowledge of demography, development economics, or neoclassical growth theory.

Using the logic of economics theory and an objective assessment of China’s reality, this book intends to combine all relevant arguments and current theories so as to form a consistent analytical framework. It also tries to draw lessons from international experiences that are relevant to China. In order to deepen the ongoing debates and reach a consensus (as much as is possible in this type of analysis), the book clarifies scholarly concepts through various means. The author does not, however, expect unanimous agreement across all issues; only if scholars and policy makers can recognize the urgent challenges confronting China in avoiding the middle-income trap will this book have attained its objective.
China's economic growth prospects

This book is also intended to be, however, an ambitious by-product of the applicability of economic theories born and developed in the west to China's unique experiences with economic development. During the second half of the twentieth century, various theories of development economics, for example Arthur Lewis's dual economy development theory, experienced both a rise and a fall insofar as they dominated the economic thinking of developing countries' economic catch-up. Their disappearance from the scene was due largely to the critics coming from neoclassical economics, although accepting the latter invites various unrealistic assumptions, for example that of a limited and constant supply of labor, that are not appropriate in explaining the realities that exist in developing countries.

China's successful economic growth since it initiated its reform and opening-up policies in the late 1970s cannot be fully explained by any single theory of economics. Different stages of economic development may follow different economic laws with possible variances. In this book, various economics theories are applied when they fit the practices and stages of China's economic development. The author tries to make the analysis consistent with economic theories while avoiding the rote application of western economics.

In what follows, the Chinese experiences with economic development are thoroughly discussed using a comprehensive analytical framework. Chapters are committed to proving the arrival of the Lewis Turning Point and the disappearance of the demographic dividend, and to depicting China's unique feature of growing old before getting rich, as well as its relevance to the country's risk of falling into the middle-income trap. Furthermore, the book aims to draw policy implications and suggest ways in which China can deepen reforms so as to sustain economic growth and social progress after exhausting the conventional sources of growth based on its demographic dividend.

Putting Chinese economic development—past, present, and future—in a wide framework that attempts to explain the global phenomena of the great divergence and great convergence, Chapter 1 discusses why the dominant neoclassical economics failed in guiding, explaining, and predicting the practices in China and other developing countries, points out where the Chinese economy presently rests based on international experiences of economic slowdown, and raises a question about whether and how China can avoid the middle-income trap and realize its great renaissance.

Chapters 2, 3, and 4 explore the applicability of Lewisian theory to the transitional Chinese economy and narrate the process of dual economy development that has run parallel with the economic reform and opening-up in China since the late 1970s. Combining Chinese-style system
reform, economic growth, and demographic transition, these chapters depict the phenomenal labor migration of the country, estimate the quantity and proportion of agricultural surplus laborers, and map their changes over the period from the late 1970s on. Based on the empirical examination of economic development and demographic transition, we conclude that the arrival of the Lewis Turning Point manifested itself as a labor shortage and wage increase and, consequently, the demographic dividend that the Chinese economy has enjoyed for so many years began to disappear.

In the following two chapters, Chapters 5 and 6, we reveal the unique characteristics concerning the relationship between economic development and demographic transition in China. For one thing, China has reached a higher phase of population aging with a relatively low per capita income. Such a property—commonly phrased as “growing old before getting rich”—poses particular challenges to the sustainability of China’s economic growth and thus makes the phenomenon of the middle-income trap exceedingly relevant to China. Based on a review of economics literature and development experiences, Chapter 6 argues that not only does the so-called middle-income trap already exist in global economic history, but it is particularly applicable in comprehending the future of Chinese economic growth.

In Chapters 7 through 12, we attempt to debate issues of how China can avoid falling into the middle-income trap. Chapters 7, 8, and 9 discuss how to exploit new sources of economic growth primarily by focusing on enhancing the potential growth rate through tapping the potential of the labor supply, improving total factor productivity, and accumulating human capital, as China is facing diminishing traditional sources of growth. Drawing lessons from other countries and applying them to the situation facing China presently, we suggest ways of sustaining the growth rate from supply-side factors instead of demand-side factors, since the latter demands stimulation policies and therefore increases the risk for China of falling into the middle-income trap.

Whereas economic growth is increasingly reliant on the creative destruction mechanism as a necessary condition of total factor productivity growth—namely, those enterprises that have lost their comparative advantage, competitiveness, and therefore viability in the market will have to cease operations—workers ought to be protected no matter which sectors and enterprises they used to work in. Meanwhile, according to international experiences, narrowing the income gap is an unavoidable task for a country at a certain phase of development if it wants to avoid the middle-income trap. By respectively discussing problems such as significant income inequality, the imperfection of labor market institutions, and the lack of social protection, Chapters 10 and 11 suggest that the key
to building labor market institutions and social protection mechanisms, which effectively protect workers without distorting incentives, lies in redefining the boundary of functions between the government and enterprises. At the present stage of economic development, the transformation of growth sources from the demographic dividend to the reform dividend is vital if China is to manage the transition from middle-income country to high-income country. Chapter 12 elaborates on the logic that the economic reform has followed to this point and then summarizes the characteristics of the new round of economic reforms. By quantifying the reform dividends, the chapter tries to boost the confidence of the Chinese people and international observers in such reform and help decision makers to identify key areas in which immediate reform dividends can be gained. Echoing the issue put forward in Chapter 1, it concludes by asserting that reform is the only way to avoid falling into the middle-income trap and bring about an economic renaissance.