https://www.wsj.com/articles/chinas-state-driven-growth-model-is-running-out-of-gas-11563372006

CAPITAL ACCOUNT

China's State-Driven Growth Model Is Running Out of Gas

Latest data suggest China may not match the trajectory of Taiwan, South Korea and Japan

China's working-age population has stopped growing. A cleaner collects a garbage bins in Beijing Wednesday. **PHOTO:** WU HONG/EPA/SHUTTERSTOCK

By Greg Ip

July 17, 2019

10:00 am ET

New data showing the toll trade tensions are taking on China's economy are merely a symptom of a more serious malaise: The country's state-led growth model is running out of gas. A recession or crisis may not be imminent, but the long-run implications are just as serious. Absent a change in direction, China may never become rich.

The economy's growth slowed to 6.2% in the second quarter, a near-three-decade low. That's still pretty good for a middle-income country with per-capita gross domestic product of $14,000 to $18,000 a year, depending on how Chinese data are adjusted for inflation, exchange rates and purchasing power. It's also the fastest among major economies.

Yet from a different perspective, it's far less impressive. First, official statistics probably paint too flattering a picture. Per-capita income may be a quarter lower than reported, based on a study of nighttime light co-authored by Yingyao Hu of Johns Hopkins University. Alternative data such as tax collections suggest growth was 1.8 points slower than reported from 2010 to 2016, Chang-Tai Hsieh of the University of Chicago and three co-authors conclude.

Second, it doesn't measure up to the economies China seeks to emulate. Taiwan, South Korea and Japan all opened their economies to global trade and investment, enjoyed superfast growth for several decades, then slowed as they reached middle-income status—the early 1970s for Japan, the 1980s and early 1990s for Taiwan and South Korea. In theory, China should be able to sustain rapid growth even longer because rich countries such as the U.S. have pushed the technological frontier out further, offering more room for China to catch up.

In fact, China seems to be slowing sooner than the others. After reaching levels comparable to China today, Taiwan's per-capita income grew 7.5% for another decade, South Korea 6.3% and Japan 4.7%. Yet for China it will be "very difficult to sustain rates of growth above 4% under the current policy environment," says Loren Brandt, an expert on Chinese growth at the University of Toronto.

SHARE YOUR THOUGHTS

What should China do to sustain its growth rate? Join the conversation below.

Some of the reasons are immutable. China's working-age population has stopped growing. The big shift of labor from rural farms to urban factories is largely complete. And Andrew Tilton, economist at Goldman Sachs, notes China can no longer rely on exports as much as smaller countries because of its size: It has saturated foreign markets and generated a protectionist backlash.

China may also pay a penalty for its current growth model. For 30 years the Communist Party opened ever more of the economy to private enterprise, trade, foreign investment and market forces. Yet it never relinquished its commitment to socialism and Mr. Brandt says that since the mid-2000s the government has tightened control over sectors it considers militarily or economically strategic, such as telecommunications. Some Chinese officials "truly believe a dominant state sector is exactly what China needs to become globally and strategically important."

China today differs in significant ways from Taiwan, South Korea and Japan at similar stages of development. One is that infrastructure, most of it state-led, and housing, are much more important in China, representing half of total investment, says Dwight Perkins, a China expert at Harvard University. This made sense when the average family's apartment was just 200 square feet and even its most densely populated regions lacked freeways. Now, though, the average apartment is 800 feet, and new highways and railroads increasingly serve remote areas with less potential payoff. "It's good for those areas, but the return on that investment has undoubtedly fallen very sharply."

Another difference is China's reliance on debt, which, according to Mr. Tilton, is, as a share of GDP, two to four times that of its east Asian peers at similar stages of development. The upshot: China invests just as heavily but far less efficiently than its peers did. It shows: The return on capital plummeted from 19% in 2007 to 8.4% in 2017, according to Andrew Batson of Gavekal Dragonomics, a research service. The China Development Research Foundation, a government think tank, says total-factor productivity, which measures how efficiently labor and capital are deployed, began growing faster in 2016, led by services. But some analysts are skeptical of official data and say productivity growth has been negative for years.

ALSO

- For Boris Johnson's Britain, a Cold World Awaits July 24, 2019
- A Record Expansion's Surprise Winners: The Low-Skilled July 10, 2019
- China Knows What It Wants—the U.S. Still Doesn't July 3, 2019
- Facebook's Libra Could Give Dollar, Banks Some Welcome Competition June 26, 2019

An inefficient state sector matters less if the private sector grows fast enough. But in recent years, private firms in China have faced multiple headwinds. State-controlled banks prefer to lend to state-owned enterprises, so private firms borrow from less-regulated "shadow banks," which the authorities have targeted in their crackdown on excess lending. The domestic private sector's share of total sales has dropped about 5 percentage points since 2016, according to Goldman, while the state sector's share has risen roughly as much.

The trade clash has also hurt the private firms, many foreign owned, that dominate exports while rallying nationalists to defend China's state-centric model. China still has many reformers pressing to expand the role of private enterprise. The top banking regulator, Guo Shuqing, earlier this year denied the country owed its rapid growth to "state monopoly capitalism," said foreign and private capital can enter almost any industry, and vowed to keep opening up the financial sector. Yet Mr. Batson says the trade confrontation could make it "politically more and more difficult for people like Guo to both defend China's system against foreign attacks, and continue to nudge it in a different direction."

Write to Greg Ip at greg.ip@wsj.com