China's growth story is far from dead: it's still unfolding

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As Mark Twain famously said, the news of my death is greatly exaggerated. And so it is of the imminent hard landing of the Chinese economy under a mountain of debt, bringing with it the demise of the China economic miracle.

An undercurrent of wishful thinking runs through much of this. The China model confounds conventional economic wisdom on the respective roles of market and state and, accordingly, is doomed eventually to re-set the balance between market and state, or fail.

China has long defied dire predictions from the "hard-landing" school of analysis. Last year's official GDP growth rate of 6.9 per cent exceeded all expectations - even the government's own target of 6.5 per cent. China has now sustained growth at over 6 per cent for the past seven years, enough to increase total GDP and per capita incomes by over 50 per cent. Not bad for an economy that was supposed to be on the verge of shuddering to a crawl all those years.

Australia along for the ride

Australia has been, and continues to be, a major beneficiary of this. Despite massive increases in iron ore and coal output, prices remain higher than most forecasters expected several years ago because China has continued to surprise on the upside of its growth. And with per capita incomes rising so strongly in China – a consequence of GDP growth – Chinese outbound tourism and education continues to boom.

Statistics without context are misleading. The much-heralded debt crunch looks plausible when looking at debt to GDP of nearly 300 per cent, especially since it has doubled in six years. But when debt as a share of GDP is compared with other major economies, such as the US or Japan, while high, it is still within their range.

Similarly, whereas the US can keep funding its debt by printing dollars and thus avoid a currency crises, China maintains financial stability through a mix of tightly managed capital flows and exchange-rate adjustments, and short-term money market interventions.

Moreover, most of its debt is in yuan so in this way it is much less exposed to a potential currency crisis than other indebted economies. Although the Chinese approach may look inelegant to many Western economists, China's economic policymakers have shown themselves adept at ensuring financial stability. Their record speaks for itself.

The quality argument

While some continue to forecast an imminent rout of the China growth story, others have shifted their ground to predicting a more gradual and limited step down in the long-run growth trend, while others predict Japanese-style secular stagnation.

A new line of questioning the sustainability of China's growth has emerged of late. It concerns the "quality" of China's GDP growth. It argues that because of capital misallocation to wasteful projects – ghost cities and adding to industrial excess capacity for example – the reported growth rates should be adjusted downwards.

This is a novel approach to trying to explain why China's growth rates have not sunk as predicted. The flaw here is that GDP is only a measure of economic activity. Even building a ghost city employs workers, supports families and generates incomes that will be spent on rents, food, education and the like. John Maynard Keynes understood this when, in the General Theory, he argued that to sustain aggregate demand it would be rational to pay workers to dig a hole, fill it in and dig it over again.

The real problem

The "quality" of growth argument is also akin to one made by environmentalists: negative externalities, that is the cost of environmental damage caused by economic growth, should be deducted from GDP. Again, this misses the point, GDP is a measure of economic activity not a normative concept or a measure "quality".

The quality of growth argument does, however, point to perhaps the most serious problem facing Chinese policymakers: declining total factor productivity (TFP). Since 2011, TFP growth has been falling. It is largely attributable to capital misallocation. Over time, this will become a persistent drag on economic growth unless addressed. But at the same time, the economy still has a lot of growth momentum in it and President Xi Jinping's "supply side" policies are intended to address this. Whether they do or not remains to be seen.

As China's economy becomes more developed, growth rates will inevitably slow over time. Why there has not been a more pronounced slowing, especially as TFP growth has been falling, is the more intriguing question.

Economy of scale

It is here that the analysts who focus extensively on national aggregate accounting, and the herd of commentators who follow them, do not appreciate the importance of the sheer size and geographical scale of the Chinese economy and the deep structural changes that are under way in different regions of the economy.

The Chinese economy is, in reality, several different economies at quite different levels of economic development. A dozen or so cities in eastern China, the provinces of Zhejiang and Jiangsu, and Shenzhen and Guangzhou in the south, have developed-country levels of per-capita incomes and a combined population of more than 200 million.

So in global terms, a new developed economy has been added to the world economy in just 15 years. For this economy, the much vaunted "middle-income trap" is no longer a relevant concern. In this group, consumption drives growth, and services account for an increasing share of economic activity. As such these regions make up a big share of the economy, services are now more than 52 per cent of China's GDP and consumption accounts for about 65 per cent of GDP growth.

Playing catch-up

The next group of economies is at or near middle-income country levels. It stretches from China's north to south and comprises mainly provinces in central China. The combined population is about 800 million. For the rest, they are still at developing-country levels of per capita income with about 100 million officially in poverty. Here state-led investment in fixed capital, especially infrastructure and urban development, still dominates economic activity.

So as the more advanced areas slow, catch up on a large scale is occurring in the far more populous regions of the economy. At the same time, in a decade, China has transformed from an export-led, to an investment-led, and now to a consumption-led, economic model. This is really all just textbook economic development, but on a grand scale.

This year marks the 40th anniversary of the historic decision by the Chinese party-state to begin the process of rebuilding an impoverished, backward country by focusing on economic development based on allowing markets to play a greater role in allocating resources and opening progressively to the international economy. Yet 40 years on, the long-expected convergence of China's economy and politics towards more Western-looking arrangements has not happened. And while President Xi is in charge, there is little prospect of it doing so. The death of the Chinese economic model is a long way off.

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