

# BRIC wall

## **Growth tends to slow when GDP per head reaches a certain threshold. China is getting close**

Economic Focus

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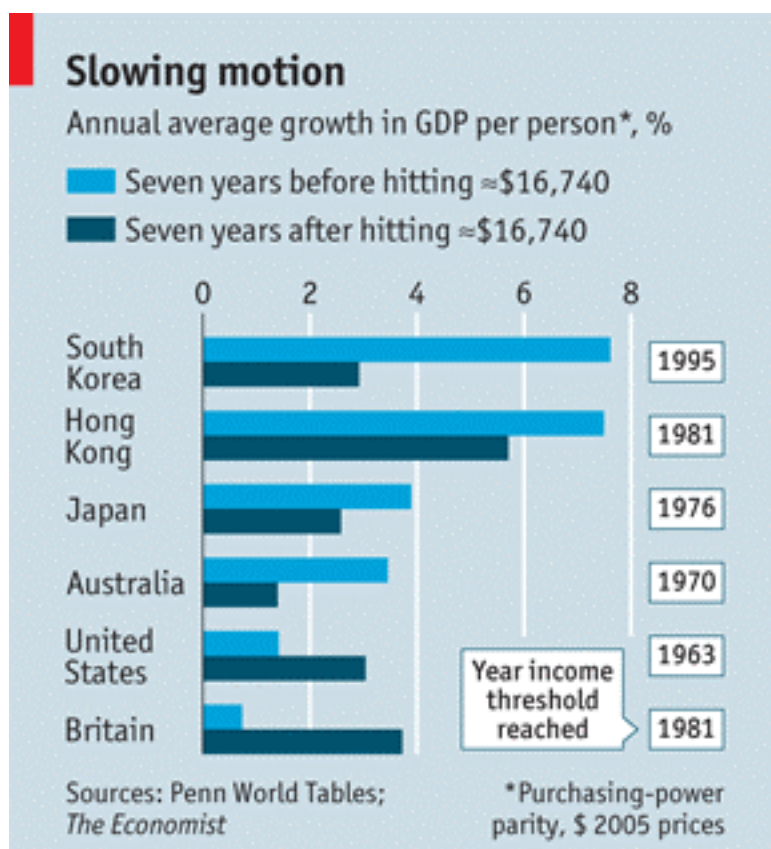
THE economic crisis may have been debilitating for the rich world but for emerging markets it has been closer to a triumph. In 2010 China overtook a limping Japan as the world's second-largest economy. It looks set to catch America within a decade or two. India and Brazil are growing rapidly. The past few years have reinforced the suspicion of many that the story of the century will be the inexorable rise of emerging economies. If projections of future growth look rosy for emerging markets, however, history counsels caution. The post-war period is rich in examples of blistering catch-up growth. But at some point growth starts to disappoint. Gaining ground on the leaders is far easier than overtaking them.

Rapid growth is initially easy because the leader has already trodden a clear path. Developing countries can borrow existing technologies from countries that have already become rich. Advanced economies may be stuck with obsolete infrastructure; laggards can skip right to the shiniest and best. Labour productivity soars as poor economies shift workers from agriculture to a growing manufacturing sector. And rapid income growth among young workers boosts savings and fuels investment.

But the more an emerging economy resembles the leaders, the harder it is to sustain the pace. As the stock of borrowable ideas runs low, the developing economy must begin innovating for itself. The supply of cheap agricultural labour dries up and a rising number of workers take jobs in the service sector, where productivity improvements are more difficult to achieve. The moment of convergence with the leaders, which once seemed within easy reach, retreats into the future. Growth rates may slow, as they did in the case of western Europe and the Asian tigers, or they may falter, as in Latin America in the 1990s.

The world's reliance on emerging markets as engines of growth lends urgency to the question of just when this "middle-income trap" is sprung. In a new paper\* Barry Eichengreen of the University of California, Berkeley, Donghyun Park of the Asian Development Bank and Kwanho Shin of Korea University examine the economic record since 1957 in an attempt to identify potential warning-signs. The authors focus on countries whose GDP per head on a purchasing-power-parity (PPP) basis grew by more than 3.5% a year for seven

years, and then suffered a sharp slowdown in which growth dipped by two percentage points or more. They ignore slowdowns that occur when GDP per head is still below \$10,000 on a PPP basis, limiting the sample to countries enjoying sustained catch-up growth. What emerges is an estimate of a critical threshold: on average, growth slowdowns occur when per-head GDP reaches around \$16,740 at PPP. The average growth rate then drops from 5.6% a year to 2.1%.



This estimate passes the smell test of history (see chart). In the 1970s growth rates in western Europe and Japan cooled off at approximately the \$16,740 threshold. Singapore's early-1980s slowdown matches the model, as does the experience of South Korea and Taiwan in the late 1990s. As these examples indicate, a deceleration need not precipitate disaster. Growth often continues and may accelerate again; the authors identify a number of cases in which a slowdown proceeds in steps. Japan's initial boom lost steam in the early 1970s, but its economy continued to grow faster than other rich nations until its 1990s blow-up.

In the right circumstances the good times may be prolonged, allowing an economy to reach a higher income level before the inevitable slowdown. When America passed the threshold it was the world leader and was able to keep growing rapidly so long as its own innovative prowess allowed. Britain's experience indicates economic liberalisation or a fortunate turn of the business cycle may also prevent the threshold from binding at once.

Openness to trade appears to be a potent stimulant: the authors attribute the outperformance of Hong Kong and Singapore to this effect. Lifting consumption to just over 60% of GDP is useful, as is a low and stable rate of inflation. Neither financial openness nor changes of political regime seem to matter much, but a large ratio of workers to dependents reduces the odds of a slowdown. An undervalued exchange rate, on the other hand, appears to contribute to a higher probability of a slowdown. The reason for this is not clear but the authors suggest that undervaluation could lead countries to neglect their innovative capacity, or may contribute to imbalances that choke off a boom.

### **Middle Kingdom, middle income**

The authors are careful to say that there is no iron law of slowdowns. Even so, their analysis is unlikely to cheer the leadership in Beijing. China's torrid growth puts it on course to hit the \$16,740 GDP-per-head threshold by 2015, well ahead of the likes of Brazil and India. Given the Chinese economy's long list of risk factors—including an older population, low levels of consumption and a substantially undervalued currency—the authors suggest that the odds of a slowdown are over 70%.

It is hazardous to extend any analysis to a country as unique as China. The authors acknowledge that rapid development could shift inland, where millions of workers have yet to move into manufacturing, while the coastal cities nurture an ability to innovate. The IMF forecasts real GDP growth rates above 9% through to 2016; a slowdown to 7-8% does not sound that scary. But past experience indicates that slowdowns are frequently accompanied by crises. In East Asia in the late 1990s it became clear that investments which made sense at growth rates of 7%, say, did not at expansion rates of 5%. Political systems may prove similarly vulnerable: it has been many years since China has to deal with an annual growth rate below 7%. Structural reforms can help to cushion the effects of a slowdown. It would be wise for China to pursue such reforms during fat years rather than the leaner ones that will, eventually, come.

\* “When Fast Growing Economies Slow Down: International Evidence and Implications for China”. NBER working paper, March 2011