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Avoiding pitfalls in China's transition of its growth model

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1. Introduction

In the aftermath of the global financial crisis of 2008, economic growth worldwide has trended downward, with the growth of the world gross product (WGP) faltering to a pace of about 2.2 per cent in 2016 (United Nations, 2017), compared with an average of about 3.4 per cent registered in the decade prior to the global financial crisis. The slowdown in many emerging economies and developing countries has been more pronounced, as some of them fell into a deep recession. Against this global backdrop, China's gross domestic product (GDP) growth has also tapered off, decelerating from the average of 10 per cent sustained for three decades between 1980 and 2010 to below 7 per cent in both 2015 and 2016.

There is a consensus among economists and policymakers that China's extraordinary growth performance over the last three decades has been remarkable by any standard (World Bank, 2013). The strong growth catapulted China to the second largest economy in the world, lifting more

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than 500 million people from extreme poverty, although in per-capita terms, many development indicators of China remain far behind those of developed economies.

China's economic growth has also been accompanied by an increasing number of new challenges, such as widening inequalities and rising costs associated with the depletion of unrenewable resources and the degradation of the environment (World Bank, 2013; Zhang, 2016). There is a growing consensus that China needs to adopt a new development strategy in its next phase of development, including a transition of its growth model. For example, China's 12th Five-Year Plan (2011–2015) placed a key focus on accelerating the transformation of its development patterns, and China's 13th Five-Year Plan (2016–2020) promoted five new development principles: innovation, coordination, green, openness and sharing (National Development and Reform Commission of China, 2011, 2016). Many analysts have also placed the issue of China's transition of its growth pattern in the broad context of global rebalancing (Hong, Vos, & Keping, 2008; Prasad, 2009).

In this regard, the recent slowdown in China's growth is considered by many analysts as, to some extent, desirable, or at least not detrimental. The moderated growth could be the necessary consequence of the transition China has adopted towards a more structurally-balanced, socially-inclusive and environmentally-sustainable economy.

Nevertheless, views are split on how exactly China should transform its development strategy and make a transition of its growth model. For example, a very popular view suggests that China should make a transition from investment-driven growth to consumption-driven growth; from export-driven growth to domestic demand-driven growth; and from manufacturing-driven growth to services-driven growth (Roach, 2013). We do not agree with this view. In this article, we rebut particularly the suggestion that China needs to replace investment-driven growth by consumption-driven growth. We will show that this view is erroneous both theoretically and empirically: consumption and investment are not interchangeable with each other to drive long-run economic growth, with the former as the outcome of economic growth, while the latter the necessary driver for economic growth. If China adopts this policy guidance, its growth in the future may slow down much more deeply than intended, unable to narrow further the remaining substantial gaps in the standards of living between China and developed economies.

This article is organized as follows: in Section 2, we will show that the view of replacing investment by consumption to drive growth is based on a misinterpretation of GDP identities in the System of National Accounts (SNA), and this view is not supported by the SNA data for many countries. In Section 3, we will revisit various theoretical growth models and voluminous empirical studies of long-run growth, showing that investment is among the key determinants of long-run growth, but consumption is not. In Section 4, we will explain the relationship between consumption and long-run economic growth, suggesting that consumers need to make an intertemporal tradeoff between the present and the future in terms of the share of disposable resources they would allocate to consumption. In Section 5, we will illustrate – through a few simulated scenarios based on a modelling exercise – how a change in the marginal propensity to consume will affect China's growth trajectory in the future. We will conclude with a summary of key findings.

2. The meaning of GDP identities in the System of National Accounts

The view that China needs to make a transition from "investment-driven growth" to "consumption-driven growth" is based on the notion that "in all economies the expansion of output is the sum of the growth of consumption (both private and government) plus investment plus net exports of goods and services" (Lardy, 2006).

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