With his recent *Critical Issues* presentation, Harvard University Harold Hitching Burbank Professor of Political Economy, Emeritus, Dwight Perkins turned the discussion to trends in the Chinese economy and the prospective role of the Third Plenum reforms in addressing economic inefficiencies and structural problems. While combating China’s economic slow down will require reforms targeting both the demand and supply sides of the equation, the “Sixty Points” of the Third Plenum mainly address production issues. If China follows through with its plans the reforms will have an ameliorating impact on the economy and ensure that the country avoids the middle-income trap, but the structural problems associated with low household consumption will remain and continue to exert a drag on the economy.

As predicted by Perkins and Rawski in 2006, the Chinese economy has been experiencing a slow down – from 9 to 7.5 percent per capita GDP growth. This slow down is not unexpected, as very rapid per capita GDP growth is only “catch up” growth and typically cannot be sustained for longer than three to four decades. In general, rapidly industrializing countries such as China slow down before they catch up with the highest income countries. China has already begun this process of slowing down for a multitude of reasons, including the exhaustion of surplus labor (the young labor from the countryside has almost entirely migrated to the cities) and an inability to sustain the high export growth rates it enjoyed previously.

Also at the crux of the slow down is China’s strange GDP structure where household consumption makes up an unusually small share (thirty-five percent as opposed to the more typical sixty percent). With such a low level of household consumption, total aggregate demand must be taken up by another sector – in China’s case investments in housing and infrastructure. From 1995 to 2011, 18.7 billion square meters of housing were constructed – enough to house 624 million people. This large expansion in housing was in many ways a response to the large need for housing at the start of the reform era, as from the late 50s to the early 80s China followed the Soviet strategy of not investing in consumer goods and no housing was built. This housing boom can’t continue forever, however, as there is a real limit to the number of houses consumers can purchase. In a similar vein, China’s incredible investments in infrastructure projects include construction booms of airports, high-speed railways, and road systems, but there are only so many more infrastructure projects left to undertake. Many of these projects furthermore will enter costly maintenance phases, which will raise recurrent costs and will maintain but not add much to economic growth. Taken together, these trends point to the need to raise household consumption to replace the investment-heavy demand structure in the Chinese economy.

Raising household consumption is a tricky problem and is only addressed somewhat in the Third Plenum’s Sixty Points. The easiest way to raise household consumption is to have wages rise at a faster pace than GDP. Labor shortages have spurred wage growth that will close the gap between GDP and wages, but this is unlikely to be a long-lasting solution. The Sixty Points
addresses increasing wages with commitments to ensure migrant pay parity with urban workers and
improve the collective bargaining power between labor and capital. Neither of these reforms are
likely to have much of an impact, however, as migrant wage standards are very difficult to enforce
and Chinese unions, dependent on the state, are unlikely to hold any real power over capital. Other
possibilities to increase domestic consumption include lowering the household savings rate by
ensuring greater state support of pensions, healthcare insurance, and education costs, and giving
individuals more diversified investment opportunities through liberalizing banking interest rates.

China is actively trying to reform its social service systems, but these reforms are unlikely to
have any major effect on domestic consumption in the next five to ten years. Liberalizing interest
rates, by contrast, is included in the Sixty Points and would have an impact on consumption: a rise
from three to five percent in the rate of return would increase income and probably consumption by
1.5 percent. Finally, also enshrined in the Sixty Points are planned reforms of the Hukou system,
which would have an impact on consumption by encouraging migrant full participation in urban life
by moving their families from the countryside to the cities. Full reform of the household
registration system is unlikely to happen quickly, however, as there is inadequate housing for
migrants in urban areas (a concern not addressed by the Sixty Points). Alternatively, the state could
increase its subsidies to the poor – subsidies equivalent to a twenty percent increase in income of the
bottom 10% of the urban population and the bottom 20% of the rural population would increase
consumption by 2.5 percent, but again a change of this magnitude is not very likely.

Without increasing wages, it will be difficult to increase household consumption and its
share of GDP. Given the difficulties posed by increasing wages, the Sixty Points mostly addresses
the supply side of GDP and increasing production productivity. In order to continue a nine percent
growth rate, total factor productivity (TFP) would need to maintain a growth rate of 3.6 percent
over the next few years and an even higher rate a bit later. China was able to have a high TFP
growth rate from 1979 to 2005 because during that period it was dismantling the inefficiencies of the
socialist era. Maintaining such a rate now will be difficult, but the goals listed in the Sixty Points
suggest China is going to try through creating a “fully marketized system”: reforming state-owned
enterprises, abolishing administrative monopolies, and liberalizing interest rates. Significantly, the
plan also calls for withdrawing “from industries where the market can regulate.” China today has
some of the highest rates of regulation in the world, making it a difficult place to do business and
open to abuses of power by local officials who have a large degree of discretionary power over
regulatory decisions.

China’s plans for increasing supply side productivity are numerous and could ensure a
continued high level of economic growth, but the question remains whether the government will
fulfill its promises listed in the Sixty Points. If China is successful, it will be able to sustain a GDP
per capita growth rate of five to six, maybe seven percent for the next decade or two, ensuring its
ascension to the ranks of the high income countries and avoiding the pitfalls of the middle income
trap. Nevertheless, the massive structural problems associated with low household consumption will
not disappear anytime soon.