"Middle-income Trap" and Internal Confliction of China's Economic Development Model

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Abstract: China is in substantial risks of falling into the "middle-income trap". This paper states the concept and causes for the "middle-income trap", analyzes the internal confliction faced by China's development, and puts forwards three major risks existing in China's economic growth model, namely big economy and small engine, factor input and factor return, and resource dependence and resource capacity. China's economy is confronted with the double restrictions of internal resource bottleneck and external market shrinkage, and faces a high risk of falling into the "middle-income trap", which should be treated with great caution. In this context, changing the economic development model serves as an essential means of overcoming the so-called "middle-income trap".

1. The concept of "middle-income trap"

In 2006, the World Bank put forward the concept of "Middle Income Trap" in Report on the Economic Development in East Asia (2006), defining it as a phenomenon where: a country sees a fall back in economic increase rate and thus remains in the middle-income section after evolving from a low-income country into a middle-income one, which stop it from making further achievements and entering the high-income camp.

According to the newest grouping standard made by the World Bank in 2015, a country with a per capita income of less than $1,045 is deemed as a low-income country; that with a per capita income between $1,045 to $4,125 is seen as below-average one, while that between $4,126 to $12,735 an above-average one, and that with a per capita income of higher than $12,736 is classified into a high-income country[1]. As per such data provided by the World Bank, China was a low-income country before 1997, entered the below-average camp from 1998 and ascended as an above-average country since the year of 2010[2].

Most economies in the world have been lingering in the middle-income section for long, showing low potentials for entering the high-income ranking, thus a "middle-income trap" is generated, especially with the major economies in Latin America. Currently the countries publicly recognized as having realized the transition from middle-income into high-income include Japan and "the Four Asian Tigers", namely, such countries have overcome the "middle-income trap". However, among them, only Japan and South Korea enjoy a comparatively large economic scale and values for research. It took about twelve years from 1972 to 1984 for Japan to evolve from a middle-income country with a per capita income of $3,000 into a high-income power enjoying a per capita income of more than $10,000, while South Korea invested in 8 years from 1987 to 1995 to ride into the high-income camp, by which time it achieved a per capita income of $11,469. As China has ranked among the middle-income countries for eighteen years, the sensitive yet significant issue of "middle-income trap" has aroused broader attention among scholars both at home and abroad.

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[1] World Bank: How are the income group thresholds determined? , 2015. https://datahelpdesk.worldbank.org/knowledgebase/articles/378833-how-are-the-income-group-thresholds-determined

[2] State Statistics Bureau: Our International Status Is Improved Significantly and the International Influences See Remarkable Enhancement — An International Comparison of China's Economic and Social Development since the !8th NCCPC

2. The essential cause for the "middle-income trap"

In analyzing the challenges faced by East Asian countries, Japanese scholar Ohno[3] proposed that these East Asian countries would reach the "transparent ceiling board" during the rising up of their economy. In another case, the American economist Barry[4] held that the reason for the fall of increase rate in the rapidly growing economies was the exhaustion of some advantageous factors in the previous stage of economic increase, such as the using up of rural surplus labor. The simple truth is that economic growth relies more on the service industry instead of the manufacturing sector, and that technological development leans more on technological innovations than introduction and borrowing.

Seen from the above, the "middle-income trap" refers to the phenomenon where a country presents a long-term stagnancy and lingering in its economic growth due to the incapability of getting rid of the conventional development model during its transition from being a middle-income country into a high-income one, which stops it from rising into a high-income power. The "middle-income trap" is in essence a trap of growth, and an aftermath of the middle-income countries' failure in transformation.

Here are in all three types of reasons determining the growth of economy: first, long-term factors of economic development, such as population, resources, level of technological development, etc.; second, economic policies, including import substitution and export-orientation; third, institutional factors, such as national welfare systems, financial repression under the financial system and the like. These three types of factors are very likely to influence each other, supplement each other and even produce reciprocal causation effects; some of them stand as the determining factors while others the secondary causes, or some play the underlying role and others express superficial phenomenon. The author holds that the first type of factors, namely population, resources and technological improvements constitute the long-term factors for economic development, serving as the deep causes in determining economic growth, while the second and third categories, namely the national economic policies and systems play the transient role throughout the development of economy. Among the countries stuck in the "middle-income trap", countries in Latin America suffer criticism due to their import substitution policy, while Malaysia undergoes slowed economic increase rate due to the defects in its export-orientation strategy. Unequal distribution of income and shortage of public welfares are generally considered as the institutional causes for the "Latin American trap", while the vulnerable financial architecture and insufficient surveillance on financial risks in Malaysia, Thailand and Philippines give rise to the severe financial shocks and lack of delayed effects on economic growth they're confronted with. Consequently, economic policies and institutional systems are merely makeshift factors during economic progress, instead of the generalized causes for the "middle-income trap". And admittedly, these economic policies and systems do not carry properties of being right or wrong; they only differ in adaptability.

To maintain prolonged growth, the development strategies, growth pattern, economic policies and systems of the middle-income countries must be adjusted accordingly with population, resources, environmental restrictions and the change of demand. When ascending from a low-income country to a middle-income one, the competitive edges of these countries mainly come from their low-cost labor force, land and resources. Once they jump into the middle-income ranking, with the expanded pressures of population structure and land resources, the rising of factor costs, and the limited resources and environmental bearing space, the competitive forces of enterprises will decline, delayed effects of economic growth will be dampened, and the paces of economic progression will slow down, all contributing to the prominent phenomenon of "middle-income trap".

In a nutshell, incentive systems for economic growth shall be timely switched off in accordance with the developing stages. With the changes of population, resources, environment and technology,

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[3] Kenichi Ohno. "Overcoming the Middle Income Trap: The Challenge for East Asian High Performers", Working Paper, Presented at WB Conference. 2009

[4] B Eichengreen, D Park, K Shin: When Fast Growing Economies Slow Down: International Evidence and Implications for China. Asian Economic Papers, MIT Press, vol. 11(1),pages 42-87, February. 2011

previous momentum for economic growth no longer functions, by which time transforming dynamic mechanism will become the crux to avoid the "middle-income trap". Based on this, obstacles in economic development model transformation will increase the odds of being caught with the "middle-income trap".

3. Internal confliction of China's economic development

Despite China's fast-growing economy with an increase rate of 6%, and the accelerated industrialization and urbanization drives, as the internal and external restriction conditions for economic growth are ever shrinking, the previous development model finds it hard to sustain itself. Based on the root causes for the "middle-income trap", we conduct a contrasted analysis on the internal contradictions and risks of China's economic development model.

3.1 Big economy and small engine

By far, the economic development models of developing countries could be roughly divided into the following three categories. The first model is the Latin American model spanning Brazil, Mexico, Chile, Argentina and other Latin American countries, which is characterized by policy collocation of Fll (Foreign Indirect Investment) and import substitution. The second is the Middle East model represented by petroleum-rich Islamic states in the Middle East including Saudi Arabia, the United Arab Emirates, and Kuwait, where the development of petroleum export and petroleum-related industries fueled by their rich natural resources gives full play to the fast expanding of international market. The third is the East Asian model manifested by the newly industrialized countries since the 1990s with China as the core by borrowing "the Four Asian Tigers" model (Hong Kong, Taiwan, Singapore, and South Korea) boomed in the 1970s, and the major policies coordinated with this development model include the taking in of FDI (Foreign Direct Investment) and export-oriented strategy.

At present, the East Asian economic development model represented by China is in nature a "dependent" one, which features the reliance on negative distortion of factors to invest foreign capital and high-quality factor flow, and a high degree of dependence on investment and export, as well as the external market to increase overseas market demand to boast economic growth.

The reliance on the external market, especially the development model with a deep reliance on the European and American market did once make a hit in such regions as Europe and Japan. However, with the gradual establishment of the new international economic pattern, the high economic status the US used to possess declined, while the economic strength of China and other emerging marketing economies sees increasing improvements. Truth is a relative term, which will deteriorate into a fallacy when going beyond a certain range. The US could no longer open up its market to the world like it once did in the 1960s and 1970s. Moreover, the economic development model represented by "the Four Asian Tigers" catered to the development demands of small economies. As a big economic power, how big an external market and how much horsepower do China call for to stimulate its economic growth? Although mainstream scholars are convinced that after China transforms its industrial structure from manufacturing-oriented to service-based, it will be hard for it to find a manufacturing production system whose market capacity is compatible with its service industry. Consequently, in a certain period of time, China's economic development will remain lying on the stabilization and consolidation of its manufacturing-power status in the current international division system[5]. However, when the day comes the only superpower in the world, the US, fails to accommodate China's huge manufacturing production system, which place or region could China deploy its production of manufacturing industry? In the meantime Chinese enterprises closely focus on target markets in European and American, the immense potential of China's consumer market becomes an important factor drawing transnational corporations. Compared with the broad domestic market space possessed by big economies, the external market is confined to a

[5] Institute of Economics of Renmin University of China: Rebalance of Global Economy and External Risks of China's Economy. *Analysis and Forecast on China's Macro-econom,* the first quarter of 2010.

limited capacity, and in this way, the economic development model for big economies unavoidably tends to be introverted. Thus relying on the internal market to boost economic growth becomes an inevitable way for stressing sustainable development.

3.2 Factor input and factor return

The substantive characteristic of China's economic growth model lies in attracting FDI to inflow through low-quality factors, and relying on the expansion of factor input scale to trigger economic growth. In the process of FDI inflowing, China serves merely as a cooperative platform for global productive factors, while the rights to allocate and yield factors are dominated by the foreign capitals, giving rise to the extreme imbalance between the income return and the economic benefits created by such factors.

The income distribution principle tailored as per factor proprietorship enables the developed countries to take over the majority of the capital investment return, and thus is advantages to these developed countries, especially to the US which is in control of the global financial assets and monetary wealth. The return of low-quality factors in developing countries is majorly transferred into reproduction of labor force, and eventually into consumption. While the return of high-quality factors in developed countries continues the re-accumulation of capital, which is finally expressed as the accrual of financial assets. In the process the developing and developed countries make joint efforts to boost global economic growth in the form of factor participation, countries of different types and with different development models vary greatly in the speed of factor return and wealth accumulation. Owing to the extreme imbalance between the scale and return of factor input, factor prices remains in a long-term low state, which aggravates FDI inflow. With factors and industries conglomerating in China and other regions in East Asia, a vicious cycle is gradually forming, resulting in the repetition and intensification of this type of economic development model along its historical path.

3.3 Resource dependence and resource capacity

Once China leans its economy on low-cost inputs, "hard restraints" in respect of resources will be brought about. As a big power with a population of 1.3 billion, China is in nature in a lack of resources, where the contradiction between its economic development model featuring resource dependence and the ever-contracting of resources' bearing space is being increasingly intensified. The results can be seen from the following two aspects:

3.3.1 "Demographic dividend" disappearing.

China's population structure encountered inflexion in 2015. It's indicated that the low-cost growth pattern based on population has already ended and "demographic dividend" has disappeared. According to the sixth demographic census, the proportion of people aged above 65 years old was 8.9%, higher than the 5.3% of the other developing countries. The negative effects arising from population aging have started to show, and China's economy is now facing a prematurely decadent situation. Japan's economic growth rate once reached up to 9.2% during its population dividend period, while such figure declined to 3.8% with the disappearing of the population dividend. By 1990, as the population dividend completely vanished, its economic growth rate presented a new low of 0.89%, triggering the "Heisei Depression" in economic course. It can be imagined that with the change of China's population structure, its resource allocation pattern will alter accordingly. When the "population dividend" expires, the period of high economic growth will meet its end, a new trend of declined saving rate and reduced investment will come into being, and China's economic growth will see a higher likelihood of deceleration.

3.3.2 Higher energy consumption.

With the rapid expansion of China's scale of economy, the extensive growth model calls for increasingly higher demands on energy consumption, whereas China doesn't enjoy infinite low-cost resources to facilitate the entire world. Calculated by the per capita share of resources, China ranks low among the world, provided its per capita share of water resources which takes up 1/4 of the world average, arable land of 30% and forest resources of 4%. Among the developed 45 major mineral resources, only 21 could be exploited to satisfy the needs of economic and social development; staple mineral resources excluding coal are in severe short supply. One important indicator measuring a country's energy consumption is energy consumption per unit of GDP, namely, GDP calculated as per the purchasing power parity created by the consumption of each kilogram of petroleum. In accordance with the data provided by the World Bank, China registers a GDP created by per unit energy consumption of about $3, while that of developed countries such as the US, Germany and France is as high as $7 or 8. On the whole, developing countries in East Asia and the Pacific region and low-income countries present energy consumption per unit of GDP lower than high-income countries, whereas China is below the average figure provided by East Asia and low-income countries, let alone the fact that the gap with developed countries is even higher. At present, the increase rate of China's energy consumption is way too higher than the world average, with the fastest increase rate centering on heavy industry sectors, including steel, cement, calcium carbide, coke, mechanical engineering, chemical engineering and so on. These industries are also the great consumers of resources and energy. Under the "hard restraints" of China's resource reserve, the contradiction between energy consumption and energy bottleneck is becoming more and more prominent.

4. Conclustion

China is in substantial risks of falling into the "middle-income trap", which should be treated with great caution. China is facing the internal challenges resulting from resource shrinkage, as well as the external restrictions led by trading barrier, showing that the growth approach adopted for the past three decades is hard to maintain for long. The competitive behaviors from local governments and the central government's frequent reliance on the governmental investment totaling 400 billion yuan to boost economic growth has not only distorted resource distribution but also generated over-consumption on the resources, which only functioned as a "makeshift measure" for crying needs but couldn't be employed in a long run. The development model depending on resources and external market brings forth the inner instability of China's economic growth. The essential measure for China to avoid the "middle-income trap" lie in transforming economic growth model, shifting from the factor-driven model to efficiency-based one and relying on institutional and technological innovations.

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