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Can China Avoid the “Middle Income Curse”?

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In June, global financial markets briefly shuddered when SHIBOR interest rates spiked to 13%. SHIBOR, the Shanghai Interbank Offered Rate (similar to its namesake LIBOR), is the interest rate Chinese banks apply to each other when borrowing overnight to maintain adequate cash reserves. In April, the overnight SHIBOR rate stood at 2% before first creeping higher in May and then exploding upward in June when the People’s Bank of China (PBOC - China’s central bank) initially refused to bail out a mounting cash crunch inside the nation’s banking system. After giving bankers this firm slap on the wrist, the PBOC ultimately injected cash into the banks bringing overnight SHIBOR rates back down to 3.4% in early July.

Since embarking on its gradual shift away from Communism in 1978 the Chinese economy has grown more than 60 fold, an average of 12.5% per year. While the United States suffered through the bursting housing bubble and financial crisis, the Chinese economy increased in size over the past decade from \$1.3 trillion to \$7.3 trillion. On a per capita basis, Gross National Product (GNP) grew from \$1,038 in 2001 to \$4,940 in 2011.

With hindsight we now know that China was only able to delay its day of economic reckoning. As economies contracted in the United States and Europe, Chinese exports fell. The Chinese government responded with a massive stimulus program largely financed with inexpensive credit from state owned banks. With manufacturing activity slowing, most of the cheap capital fueled a real estate boom. For a few years increased construction met untapped demand, but it now appears that China may be overbuilding.

The PBOC and the newly installed Chinese government are taking more decisive action to contain the real estate bubble before it spirals out of control. Due to the opaque nature of Chinese bank financial statements and mistrust of China’s economic statistics, global financial markets are increasingly jittery as they try to sort out the potential impact of China’s banking problems.

Unlike the United States or Europe, Chinese banks are not well integrated into the global financial system. As such, mounting loan losses or even insolvency would not likely impact financial institutions outside of China. Rather, the chief fear is a sharp deceleration in Chinese economic growth rates, or even a recession. While China is the export powerhouse to the rich developed world, for poorer

emerging countries China is the big importer of their products and commodities. Decelerating economic growth in China contributed to slower growth in many emerging markets in recent months and also contributed to the 9.5% decline in the MSCI Emerging Market Stock Index during the first half of 2013.

In our view China is approaching a critical moment of decision. Even if they successfully tackle their banking problems in the relatively near future – which we believe they will – Chinese economic growth could further decelerate unless significant reforms are implemented. The Chinese economy is graduating from its low income roots and entering the middle class by world standards. While per capita income of \$5,000 is still substantially below the U.S. average of \$48,000, greater prosperity also brings greater economic and social complexity to which China's legal and regulatory institutions must adapt.

China: Rules vs. Relationships

The Chinese economy is largely based on “guanxi” or networks of personal relationships and connections. Of particular importance are relationships between business leaders with government officials – local, regional and national. While guanxi fosters trust and reciprocity among narrow groups of individuals, it is much more limiting for economic activities that require large scale aggregation of capital from thousands or even millions of people. Common examples include credit cards, insurance policies, small business loans, accounts receivable financing, and, of course, stock and bond markets. When operated on a large scale the suppliers of capital are most often anonymous to each other and the borrowers. For people to part with their money under these circumstances they must have greater faith in institutions, systems and fair rules of the game in addition to personal relationships.

The GHP Global Markets Governance Gap Index

Exhibit 1 is a snapshot from the GHP Global Markets Governance Gap Index for China. We developed the Governance Gap Index to help us compare the rule of law in countries around the world. With the possible exception of small countries with large oil resources, it is very difficult for a country to become wealthy without a solid legal foundation. Recognizing this principle, the World Bank collects data related to regulatory quality, corruption and legal system performance. Using this data (which is current through 2011) our index measures the “gap” between actual economic performance and a country's potential. Developing countries, like China, that improve their governance over time can grow at very rapid rates, but if improvements stall then economic stagnation can ultimately result.

Using the United States as our benchmark the Governance Gap Index indicates that China's legal system is only about 13.4% of U.S. quality (see the green box). The blue bar indicates China's actual GDP per capita (\$4,940 in 2011). The purple bar is our estimate of how much higher GDP per capita could be based on China's current legal system quality (an additional \$1,551 in 2011). In recent years the purple bar has been shrinking as the rule of law deteriorated somewhat and Chinese incomes are approaching their potential. From a longer term perspective, however, China has made periodic leaps in governance quality. The most notable reforms were enacted in 2004 and 2007 when the Chinese government legalized private property for the first time. Further improvements are likely since China is developing a Civil Law code often using Germany as its model.

Decelerating economic growth in China is not just a short-term cyclical response to policies designed to contain a real estate bubble and potential banking crisis. Rather the Chinese government must soon adapt its legal system to a more complex economic structure or growth could stagnate. This is not the first time Chinese leaders have been confronted with this challenge. At each critical juncture over the past 35 years, China tweaked its legal and economic systems to adapt to changing circumstances and to maintain growth and social stability.

This time may prove difficult, however, since there are many more affluent, entrenched and politically powerful groups benefiting from the current system that could thwart reforms that might benefit Chinese society as a whole, but could threaten their power and prosperity. This phenomenon has happened so often in the past that economists sometimes refer to it as the “middle income curse.” We will continue to monitor the direction China’s leaders and people choose, but their history does provide some encouragement even if their current policies have not yet adapted to their new realities.

Exhibit 1

■ GDP/C ■ GAP — Potential GDP — GHPIA Gov Index

