

## Why is China Following a Capital-Deepening Development Path?

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Since the late 1990s, China's development path has deviated in major ways from the commonly prescribed market fundamentalism of Neo-Liberalism. This Development Viewpoint summarizes and evaluates some of the most important features of China's development strategy.

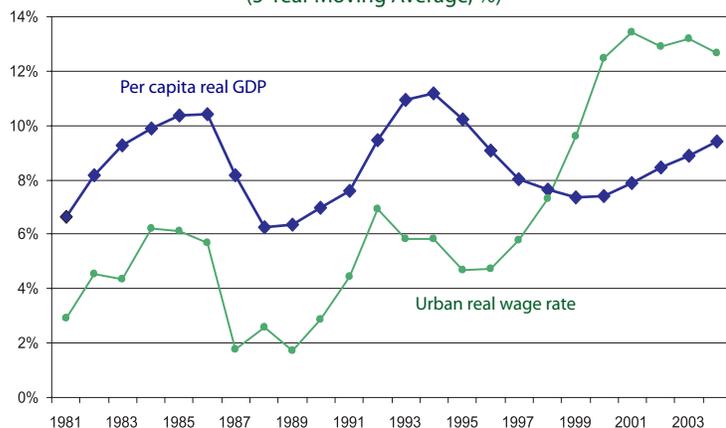
After the East Asian financial and economic crisis, during 1998-2002, Chinese economic policies began to clearly diverge from orthodox market reforms. Subsequently, governed by a general policy line focused on "constructing a harmonious society", Chinese policymakers have emphasized a pattern of economic growth based on enhancing the compensation of labour instead of constraining it.

During an earlier period, namely, 1978-1992, China was able to sustain a rapid rate of economic growth that was accompanied by a similarly brisk increase in employment. However, such employment generation was attained through wage stagnation—i.e., maintaining a cheap supply of labour in order to boost the export of manufactures.

Since roughly the mid-1990s, in contrast, a significant increase in real wages has accompanied rapid economic growth—but at the cost of a slowdown in employment creation. See the figure for the growth of real GDP per capita and urban wage rates. After about 1998, in fact, wages have increased faster than GDP.

In the early part of the reform era, the character of China's economic growth was principally labour-intensive. This phase succeeded in the monumental task of transferring a massive number of labourers in rural areas, and in agriculture in particular, to urban industry and services, where labour productivity levels were higher and increasing rapidly.

**Annual Growth Rate of Per Capita Real GDP and Real Urban Wage Rate**  
(5-Year Moving Average, %)



Sources: China Statistical Yearbook 2006; China Statistical Abstract 2007

### Capital Deepening

After the mid-1990s, China's growth became more 'capital-deepening' in character. Increasingly, capital began to substitute for labour in the modern sectors of the economy. As a result, after having declined steadily

from 1982, the incremental capital-output ratio of the Chinese economy began to increase in the mid-1990s, reaching the level of about 3.5 by 2003 (Dic Lo 2007).

Neo-Liberal advocates of market reforms argue that such a path is contradicting China's comparative advantage, which should be based on relatively cheap and abundant labour. But China's reliance on cheap labour before the mid-1990s implied that real wages were effectively frozen for an extended period of time, particularly in the labour-intensive, export-oriented industries in the coastal provinces.

During the earlier period, consumption demand expanded rapidly. But after the late 1990s, investment demand overtook consumption demand as the principal driving force of aggregate demand.

After the East Asian crisis, the Chinese Government explicitly undertook activist fiscal policies, which involved increasing public deficits and expanding public investment. Because such investment was mainly in infrastructure, it had significant crowding-in effects, ushering in the massive expansion in total investment from 2001 onwards. As a result, the trend towards capital deepening of the economy accelerated.

### Rising Wages and Productivity

Real wages have increased, principally because of rising labour productivity but also because of a resurgence of union membership, increased enforcement of minimum wages and the strengthening of government protection of labour rights. In addition, the Government has re-emphasized redistributive measures, expanded social welfare coverage and endeavoured to reconstruct a publicly funded health-care system.

These factors have contributed, directly or indirectly, to enhancing the compensation of labour, and thus to promoting a more 'harmonious society'. China is experimenting with a new model of development, both capital deepening and compensation enhancing. But, in response to the continued slow growth of both employment and consumption, should China revert to a strategy fostering labour-intensive growth? Returning to such a 'cheap-labour' strategy is probably neither feasible nor desirable.

One of the chief aspects of recent globalization trends has been the dramatic expansion of the world labour market. East Asia has accounted for about half of the quadrupling of the effective global labour supply between 1980 and 2005. China alone now accounts for about one fourth of workers producing for the global market.

But the sustainability of that model is likely to have been exhausted. China cannot continue basing its growth on the cheapening of labour, as it did through much of the 1980s and 1990s. Capital deepening that implies broad-based increases in labour productivity, and therefore in real wages, represents the most promising basis for China's development, enabling it to close the gap between its low income levels and developed-country levels.

References: Dic Lo (2007) "China's Quest for an Alternative to Neo-Liberalism: Market Reform, Economic Growth and Labour", *Kyoto Economic Review*, 76 (2): 193-210. Also available as Department of Economics Working Paper No. 153, SOAS, <http://www.soas.ac.uk/economics/research/workingpapers/>