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The Potential Solution for China to Stop Falling into the Middle-income Trap

--A Case Study of 1950-1990 Japan

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Abstract: Over the past three decades, China has made remarkable strides in economic development, transitioning from a low-income status to a middle-income nation. However, China currently faces challenges transitioning from a middle-income to a high-income country. Similarly, Japan was facing the same problem as China during the 1960s. With several successful economic policies, Japan witnessed significant economic convergence since the 1980s. The process comprises transitioning from a low-income country to a middle-income country, followed by advancement to a high-income country.Unlike many developed nations that began from a relatively advanced base, Japan initiated its journey from a less developed position, making it a particularly instructive model for other developing nations. Therefore, could China potentially adopt Japan's successful policies to navigate this transition? This paper will discuss how China might glean insights from countries, with a particular emphasis on Japan, to overcome the challenges of the middle-income trap.

Keywords: East Asian economy, Middle-income trap, policy-making, China

1. Introduction

Middle-income countries have shown rapid convergence in the economy since the 1960s. Asian countries such as Japan have a similar per capita income as the United States and continue to grow consistently. China has also achieved enormous prosperity since the 1980s by launching a series of governmental policies, including market reforms and international trade [1]. However, as Lee stated, the twenty years of delay is one of the main reasons why China is still transforming from a middle-income country to a high-income country.

2. Contemporary Chinese Economy

Three stages of economic development can be observed from the economic growth model. The first stage is a progression from low-income to lower-middle income status, which involves high agriculture and low value-added process. Followed by the second stage, which is a transformation from lower-middle income to high-middle income country. If the country completes the transaction, it will proceed to the third stage, which becomes a high-income or developed country. However, if they fail to process, the economy will fall into the middle-income trap. Zhou et al. found that quite a

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few economies which had successfully transformed from low-income status to middle-income status could not mutate into high-income status [2]. Previous studies proved that China might fall into the middle-income trap as being 'squeezed between low-wage poor country competitors that dominate in manufacturing industry and the rich-country innovators that dominate in industries undergoing rapid technological change (p.5)' [2]. A governmental policy that breaks the middle-income status is necessary.

3. The Development of the Japanese Economy

3.1. A Brief Introduction

The 2021 Penn World Table database contains the relative income, output, input and productivity levels of 183 countries from 1950 to 2019 [3]. It shows that Japan's per capita GDP was 20% of the U.S. per capita GDP in the 1950s. Japan's per capita GDP was 60% of the U.S. per capita in 1970. It peaked at 80% of the U.S. per capita GDP in 1990. Though it collapsed in the late 1990s, Japan's economy rebounded to 74% of the U.S. per capita GDP by 2000. Since then, Japan's per capita GDP has remained stable, equivalent to 70 % of the U.S. per capita GDP. As a reference, only by 2008, had the per capita GDP of China surpassed 20% of the U.S. GDP, whereas Japan had already done so in 1950. According to the statistics, a precise two-stage process can be observed: 1) the primary growth of per capita GDP from 1950 to 1970; 2) a secondary boost of per capita GDP from 1970 to 1990. Though a few other economies such as Korea and Singapore have overcome the middle-income trap, Japan is suitable for a comparative analysis due to its populous society, which is relatively similar to China [4]. Additionally, a pronounced discrepancy among regions exists in Chinese society due to the enormous geographical land area and population. Thus, in order to overcome the middle-income trap as a whole country, the fully developed areas can refer to the policies that the Japanese government launched from 1970 to 1990. For the less developed area, it is crucial to reach upper-middle income status first, for which the government can emulate policies launched from 1950 to 1970. Each stage will have one policy to discuss in the following paper.

3.2. Policies from 1950 to 1970

The economic growth in post war Japan is strongly connected with capital concentration. A capital intensity between large and small companies has been observed. From 1955 to 1961, large enterprise workers had an overall more rapid increase in capital per worker [5]. *Shiwayose* is a governmental policy that directly and indirectly affects wage growth. Large companies benefited from favourable taxation, and loan policies, which gradually gained dominance over small firms [5]. A noticeable fact is that small firms have significantly higher interest costs than large enterprises in post war Japan which encouraging them to follow the *Shiwayose* policy [5]. The policy also fostered a large business-friendly environment in that government banks had a preferential consideration on large companies. On the other hand, small business is relatively vulnerable in the growing market as they are easily affected by the market economy. Capital concentration is an effective process in achieving the governmental aim of economic growth [5,6]. However, one of the unintended consequences of this policy is the income gap. Japan failed to close the income gap between medium-small factory workers and large firm workers. To overcome this question, the Japanese government launched a new welfare system to aid low-income households [5]. Similar policies can be launched in less developed rural areas in China to help improve the overall income of the whole country in order to reach the middle-income status. Governments can gradually aid the low-income household to reduce the effect of the income gap. This point of view echoes Zhou and Hu's [4] argument that China can move further toward economic growth if the income of low-income groups has increased.

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3.3. Policies from 1970 to 1990

One of the most efficient Japanese policies responses to the 1980s economic challenges is the open market of international trade. The Industrial Policy of the 1980s by the Industrial Structure Council reported that Japan was developing a U.S.-centred political and economic structure and had competed for modernisation with the consist of 10% of the world GDP [7]. Japanese government launched an awareness of global cooperation, including biotechnology, new materials, new energy, and new technology, as Prime Minister Nakasone instructed the Cabinet to create a free trade system for the U.S. and to proceed with import procedures [8]. Records show that on 9 April 1985, Prime Minister Nakasone issued a television call to encourage the people to be more active in the free trade market. To expand imports, he also informed citizens to purchase at least $100 worth of foreign products [8]. Japan's economic structure has transformed from export only to international contribution. An open attitude towards foreign business could become a solution for China to transform from upper-middle income to high income status. This policy needs an involvement of a friendly foreign relationship, while the political stability is one of the six China's development challenges that need to be solved [4]. They furthered their statement that political stability is the economic prosperity proposition preventing countries from falling into the middle-income trap [4]. The threats are both external and internal. Western countries, in fear of China's development, may deny and criticize China's economic achievements in democracy, workers' rights, equality, and ethnic minority rights which is known as the China threat theory [9]. Japan faced the same question in the primary stage of its global expansion in the 1980s. In order to respond to the criticism, Japan promoted more market-opening policies, including negotiations on steel, automobiles, and semiconductors with the U.S. and industrial cooperation with Europe. More importantly, a large-scale currency revaluation, the depreciation of the U.S. dollar, had appreciated the value of yen, which helped Japan expand its domestic demand and recover the economy [7]. China can apply similar policies on steel and automobiles, frontier technology, and artificial intelligence. However, the internal impact of China's political stability is far more influential [4]. As Zhou and Hu [4] stated, the next step of China's economic development is closely bounded by the Western democratic system. China is currently followed by the system negotiated between the National People's Congress and the People's Political Consultative Conference. To give up the system that is 'the most suitable path for China' as the government considered, and to embrace the Western democratic system immediately may be unacceptable for both the people and the country. In this situation, the middle-income trap becomes a political trap, and China needs a stable political environment to overcome it.

4. Conclusion

The government can reduce the possibility of China falling into the middle-income trap in two parts. For the less developed region of China, the priority is to raise workers' income. Capital concentration is one of Japan's post war policies that elaborate how to transform from low-income status to middle-income status. Large companies gained privileges from the government with a reduction in taxation and anti-monopoly protection. Local banks prefer to fund large enterprises over small firms, as they are more stable and secure. This may widen the income gap between large and middle-small firm workers, but overall, it will bring economic growth. As for the already developed area, global cooperation on free trade can be beneficial. The government can attract foreign enterprises to develop frontier technology and artificial intelligence business in China. Nevertheless, external and internal political stability is required. Thus, the middle-income trap is essentially a political trap that needs a more stable political environment rather than economic innovations.

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