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Achieving China's Next Stage of 'Catch-up'

A new series of columns from these authors will examine the national, corporate and individual ways that the country and its companies can advance to levels seen in the West

By Zhang Ying and Christopher Marquis

Over the past decade, significant debate has emerged on the extent to which China will be able to catch up to the West. There are numerous indicators on either side of this debate. Fueled by over 30 years of close to 10 percent annual growth, in 2010 China surpassed Japan to become the second-largest economy in the world. At the end of 2014, China, by one measure, surpassed the United States to become the world's largest economy. And its number of companies on the Fortune Global 500 increased from 20 in 2005 to 95 in 2014.

While many indicators suggest China's economic time has come, others suggest that there is still much ground to cover and significant challenges. First, despite the economic achievements, income inequality is high, and there is also significant variation in economic development between coastal and inland regions, between urban and rural areas, and between certain industries. For example, as infrastructure and manufacturing have raced ahead, consumer and service industries still have lagged behind. Further, there are significant structural challenges such as the middle income trap and increasing integration of the global business environment that China will need to address in order to fully catch up.

In this new series of columns, we will analyze and recommend the national, corporate and individual dimensions of how China and Chinese firms can catch up. Prior historical examples of successful national-level catching up, from Germany to South Korea, have shown the importance of state policy and strong domestic economic industry, with targeted exports. But in today's world, low-hanging export fruit has been picked and countries need to be much more effective at building domestic "software" capabilities such as education and consumption, and providing better tools for their companies and citizens to effectively integrate into the global economy. Our goal is to shed light on the key mechanisms of catching up in today's world.

The idea of a country catching up is based on historical cases of the development of Germany, Japan, South Korea, Taiwan and other countries and regions that have successfully vaulted from developing to developed country status. Theoretically, catching up can be interpreted as the ability to narrow the gap in productivity and income per capita with leading countries. Over history, countries that are catching up owe their success to a number of different reasons, for example a) the introduction of new and dynamic systems based on mass production and distribution that enabled the United States to catch up to Britain in the second half of the 19th and early 20th centuries; b) for Germany in the 19th century, catching up was enabled by new ways of organizing production, and research and development; c) more recently, organizational innovation in manufacturing spurred Japan forward; and d) development of a free market and foreign direct investment were instrumental to catching up in Singapore and Hong Kong. This shows that there are many ways that countries can advance, but also raises questions about what the formula or path by which China will be able to complete its journey.

As is well known, China's quick growth over the past 30 years has stemmed from a unique blend of state support of infrastructure development and attraction of technology transfer from developed economies. Studies attribute China's catching up to the evolutionary development of the Beijing Consensus, Which interprets China's economic growth as the function of innovations in the state sector, including close financial controls, state ownership firms, and political controls in favor of economic growth. The Beijing Consensus has evolved over the years with China's economic growth and been competitive with the traditional Washington Consensus, which views China's experience as much the same as the growth experience elsewhere, that is, as the result of financial liberalization, private entrepreneurship and political opening. In particular, we observe that in China's 30 years of fast growth, a strategy of trading markets for technology, knowledge diffusion and transfer, industrial promotion by the government, and neo-democratic centralism have been the key factors in China's catching up process. We argue that this strategy, together with Beijing Consensus and Washington Consensus, has facilitated the growth of thousands of indigenous companies, both state-owned and private enterprises.

However, there are indications that this formula may be at its breaking point. One critical challenge will be overcoming the middle-income trap, whereby the vast majority of countries that have advanced to middle income, only a handful have made the next leap to high income. These problems have appeared in South Africa and Brazil, which have been persistently stuck in this trap. Countries in this situation find their growth stalled because they are unable to effectively compete with either lower-labor cost countries or innovation-driven high-income countries. There are debates on whether present-day China is in the middle-income trap. As the economic growth rate has slowed, China can no longer economically grow and technologically advance simply by foreign direct investment and importing advanced technology, but must develop its own capability to invest abroad and develop advanced technology. However, fostering these capabilities is costly and very complex. Furthermore, as countries reach middle-income status, where individual interests overtakes collective interests, citizens are less likely to make the same sacrifices as before, and expect more from social services and the natural environment.

Taking some examples of countries that successfully escaped or avoided the middle-income trap as an example, combined with the characteristics of the global environment, we argue that at the country level, developing a reliable social capability and taking advantage of middle-class consumption are crucial for China to breaking through the middle income trap. The emerging middle class must drive economic growth via purchasing high-quality and innovative products produced by domestic firms, and thus indirectly fostering social capability via local firms' seeking high-qualified human capital. However, the problems are how to create incentives for middle-class consumption within the country and how to shape education – a key measure of social capability – to train students and future leaders to be more innovative and creative.

A key leverage point to achieve these capabilities are corporations, and we highlight a number of important roles of Chinese firms' in the development of key domestic capabilities and global integration. Chinese firms are not only the beneficiaries of a country's development, but also the key engine that will propel the country past the middle-income trap. Domestically, Chinese companies benefit from the "pull force," of growing middle-class consumption, which spurs their push into innovative and high-quality products. Innovative and high-quality products then reciprocally further drive consumption. As they advance, companies need for a large pool of high-qualified human resources at a reasonable cost increases, and so they act as a "push force" for an upgraded education system that should distribute education resources equally and respect individual's internal interests. Thus, companies can act as a hub, both benefiting from and driving catching up at the national level.

In addition to these key domestic changes, the next phase of growth at the national level will require more outward internationalization of firms and organizations. Thus, as the country more fully integrates into the global system, companies also play the leading role. Here, too, human capital and education are core issues, since many of the globalizaton problems Chinese firms have encountered have stemmed from mismatched leadership and decision-making. Even many of the most successful companies, including Alibaba, Baidu and Tencent, have been mainly successful within the "walled garden" of the economy. While these companies and many others will no doubt continue to thrive by exploiting the large domestic economy, to achieve the next stage of catch up at the national level, we believe that China needs to be more globally integrated and, more importantly, learn from the successful cases of Chinese companies expanding internationally, such as Huawei's success in Europe and Hisense in United States. These examples tell us that social capital and social and cultural adaption are very important in driving catching up at a firm level, which at the national level further emphasizes the importance of education and associated social capability. As we develop the set of columns in the future, we will focus on highlighting these key company level competencies that can be aggregated to fuel national level catching up.

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