26 January 2016

HSBC Global Research

Empire of the East

How China can grow by closing its income gaps

ECONOMICS
GLOBAL

- China is not really a single economy…there are massive disparities in living standards between its provinces
- If experience in the developed world is any guide, these disparities will eventually narrow
- More than any recent financial volatility, the nature of the convergence process will shape China's economic destiny

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For richer, for poorer

Too often, we think of China as a single country with a single currency. Yet the income disparity between China's provinces and municipalities is huge. The richest Chinese region enjoys living standards four times larger than the poorest region. In the Eurozone, the richest country of size is three times richer than the poorest. In the US, the richest state is less than two times richer than the poorest.

In sickness and in health

The disparity reflects both positive and negative factors shaping China's economy since its take-off in the late-1970s. The creation of 'special economic zones' helped boost incomes and productivity in China's thriving coastal regions. Yet the *Hukou* household registration system 'hard-wired' a process of widening living standards between China's urban and rural communities. *Hukou* limited labour mobility and, intentionally or otherwise, placed huge restrictions on economic opportunity for those in poorer regions.

Lessons from 1960s Europe

The *Hukou* system is similar to the '*Gastarbeiter*' system that operated in West Germany mostly in the 1960s. Guest workers – from Turkey, Italy, Spain, and Yugoslavia, among others – were offered work but not given access to the political and social benefits enjoyed by German citizens: guest workers were, in effect, the equivalent of China's rural workers. Only later – and only for those countries that were about to join or already in the European Union – was there significant income convergence, thanks to greater freedom of movement of both capital and labour.

China's chance

This, in turn, offers China an opportunity. With the *Hukou* system rapidly waning and with the *One Belt, One Road* initiative a possible catalyst for a 21st Century version of the ancient Silk Road, there is scope for a 'regional growth rotation' away from the wealthy coastal provinces. It will not, however, be an easy task: there is, after all, more than one way of delivering economic convergence.

Issuer of report: HSBC Bank plc

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Empire of the East

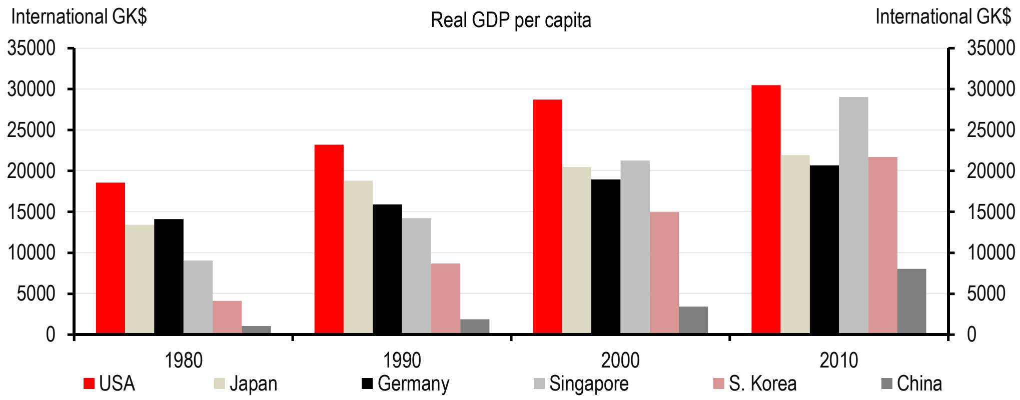
- Income disparities between China's provinces are huge
- China's future growth prospects…
- …will depend on how convergence between regions is achieved

Why traditional comparisons don't work

China's economic rise is unprecedented

Trying to get a handle on China's economic outlook is incredibly difficult for one simple reason: there is no equivalent example in history of a country so large and so populous which, despite having grown so quickly, still has a long way to go in terms of economic catch-up. In the three decades since China opened itself up to the rest of the world at the beginning of the 1980s, its living standards rose from the equivalent of those in the US in the 1790s – just after the Thirteen Colonies gained their independence – to those in the US in the 1930s. In other words, China delivered in thirty years an increase in living standards that took the US 150 years. Yet China is still only a 'middle income' country whose living standards are only between one-quarter and one-third of those in the US and China's industrialised East Asian neighbours.

1. China has grown quickly but its average living standards still lag behind

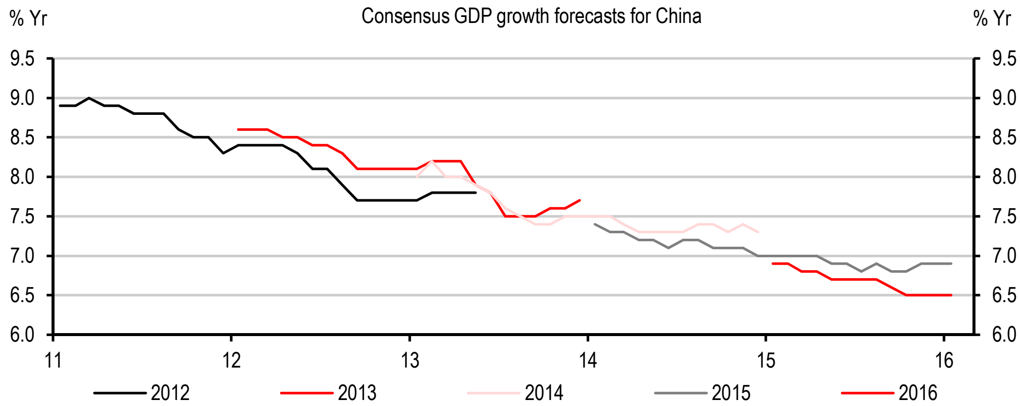


Source: Maddison. GDP comparisons made on the basis of PPP exchange rates

From boom to disappointment

China has recently been expanding at a slower rate than the consensus (and HSBC) expected. Chart 2, for example, shows revisions to consensus forecasts since 2012: initial optimism for the outlook in every year has eventually been replaced by a rather more sobering reality. Some have concluded that the game is now up for the Middle Kingdom. Its export growth engine has been spluttering ever since the onset of the global financial crisis while its more recent reliance on booming investment has triggered a decline in the marginal return on capital that threatens to unleash a debt-fuelled hangover.

2. Every year, Chinese growth is lower – and lower than the consensus expects



Source: Consensus Economics

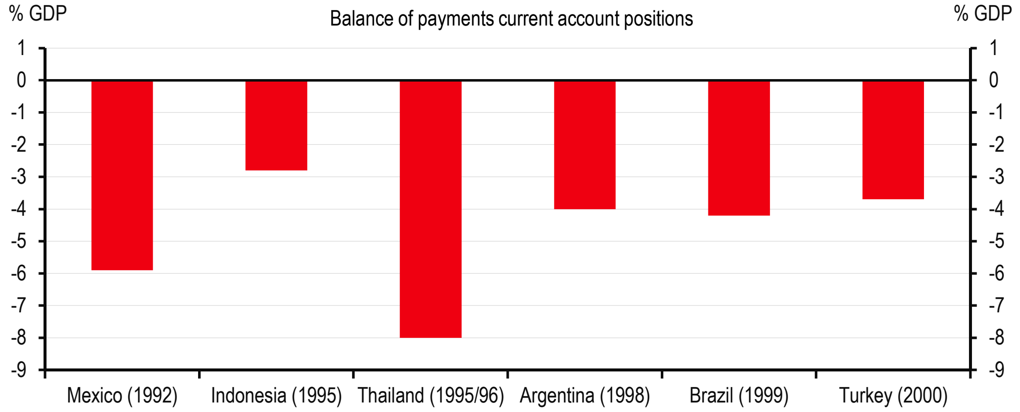
China is not a typical emerging market 'boom/bust' story, nor is it a replica of Japan

Yet it is difficult to place any of these claims in a useful historical framework given the absence of any clear precedent for China's economic transformation. Crises in countries with rudimentary financial systems tend to revolve around external financing. Emerging market booms are typically characterised by large net capital inflows, booming domestic demand and a large balance of payments deficit: the bust that follows is often associated with a 'sudden stop' as net inflows suddenly turn into outflows (chart 3). China's balance of payments surplus is a lot lower than it once was but it does not have the dependency on external finance typically seen before an emerging market bust (chart 4).

Another frequently made comparison is with 1980s-Japan. Certainly, the macroeconomic indicators are similar: a rapidly appreciating exchange rate, a sustained drop in inflation, a high share of investment within GDP, a rapid increase in indebtedness and a central bank eager to use monetary policy to support growth despite increasing signs of financial stress. Then there are common financial stability risks, most obviously stock market volatility and banking stresses. And there are also international similarities: China's attempt to 'rebalance' its economy – moving away from exports towards domestic demand in response to protectionist pressures from the US Congress and currency pressures from the Department of the Treasury – looks uncannily similar to Japan's approach in the 1980s. China's demographic outlook is also similar to Japan's thirty years ago.

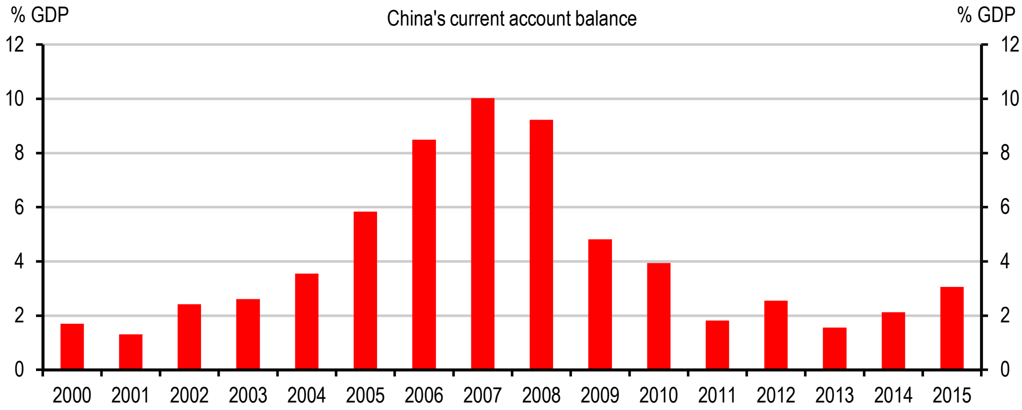
Even here, however, there is a problem. By the late-1980s, Japan was already more or less 'best in class' economically. Its per capita incomes had risen to within a whisker of those in the US, suggesting Japan was already at or close to the global technology frontier: to all intents and purposes, its period of economic 'catch-up' was over (chart 5). China, in contrast, has a lot of catching up still to do: Chinese citizens' living standards are, on average, still only a fraction of those enjoyed by their counterparts in the US and Japan. With the prospect of further economic catch-up, that makes China's debt dynamics a very different proposition to those that seriously hampered Japan's progress in the 1990s and beyond.

3. Most emerging market crises are associated with large BoP deficits



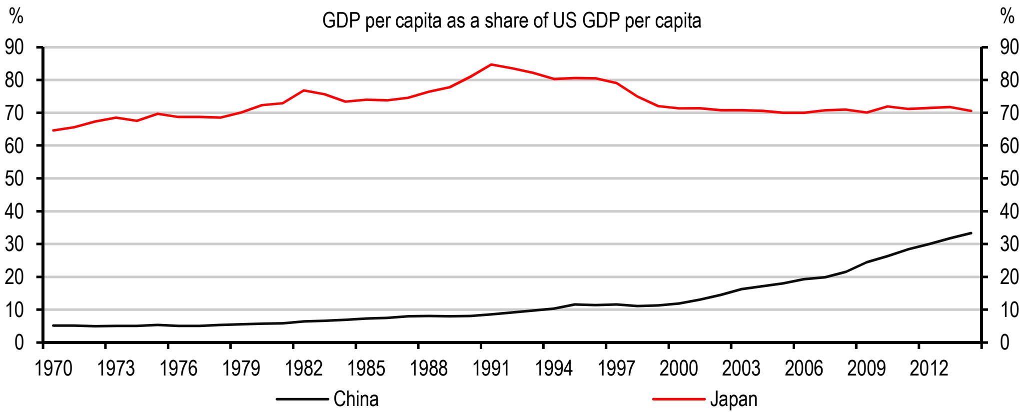
Source: IMF

4. China still has a current account surplus



Source: Thomson Reuters Datastream

5. Japan was already 'best in class' in late 1980s, China still has a long way to go



Source: World Bank, Maddison data. Note: PPP GDP per Capita.

A different approach: China as a single currency area

Think of China in bite-sized chunks

One way out of all this confusion is to split China into smaller, more bite-sized, chunks. The aggregate Chinese data are interesting but they often serve only to camouflage the huge differences in economic outcomes across the different regions. Treating China as an empire rather than as a nation state – even if almost 92 per cent of the population are ethnically Han Chinese, making it an unusually singular empire – offers a different but illuminating perspective.

China has 22 provinces (excluding Taiwan) alongside four municipalities, five autonomous regions (where the Han are sometimes a minority) and two special administrative regions (Hong Kong and Macau). Table 6 provides a list of all provinces, municipalities and autonomous regions (excluding Taiwan, Hong Kong, Macau and those regions with a population less than 1% of the total) ranked according to the level of per capita income in 2014. In that year, the richest three regions were Tianjin, Beijing and Shanghai (all municipalities) while the poorest three were Yunnan, Gansu and Guizhou.

6. China's provinces, municipalities and regions ranked from rich to poor

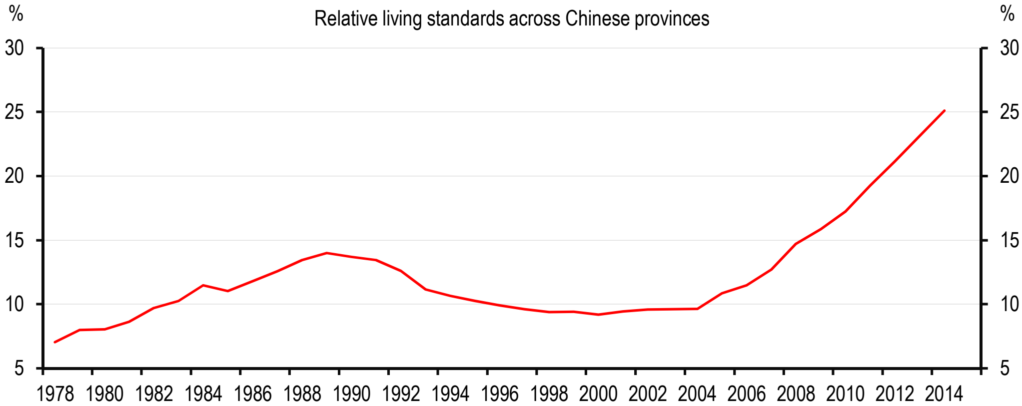
Province	Overall GDP (CNY, millions)	GDP per capita (USD)	GDP per capita relative to richest state (%)
Tianjin	1,572,247	17,126	100.0
Beijing	2,133,083	16,278	95.0
Shanghai	2,356,094	15,847	92.5
Jiangsu	6,508,832	13,329	77.8
Zhejiang	4,015,350	11,878	69.4
Inner Mongolia	1,776,951	11,565	67.5
Liaoning	2,862,658	10,614	62.0
Fujian	2,405,576	10,333	60.3
Guangdong	6,779,224	10,330	60.3
Shandong	5,942,659	9,911	57.9
Jilin	1,380,381	8,166	47.7
Chongqing	1,426,540	7,791	45.5
Hubei	2,736,704	7,671	44.8
Shaanxi	1,768,994	7,640	44.6
Xinjiang	926,410	6,611	38.6
Hunan	2,704,846	6,558	38.3
Hebei	2,942,115	6,509	38.0
Heilongjiang	1,503,938	6,386	37.3
Sichuan	2,853,666	5,719	33.4
Shanxi	1,275,944	5,708	33.3
Henan	3,493,938	5,667	33.1
Jiangxi	1,570,859	5,642	32.9
Anhui	2,084,875	5,604	32.7
Guangxi	1,567,297	5,387	31.5
Yunnan	1,281,459	4,438	25.9
Gansu	683,527	4,302	25.1
Guizhou	925,101	4,297	25.1

Source: China NBS

The gap in living standards by region has narrowed

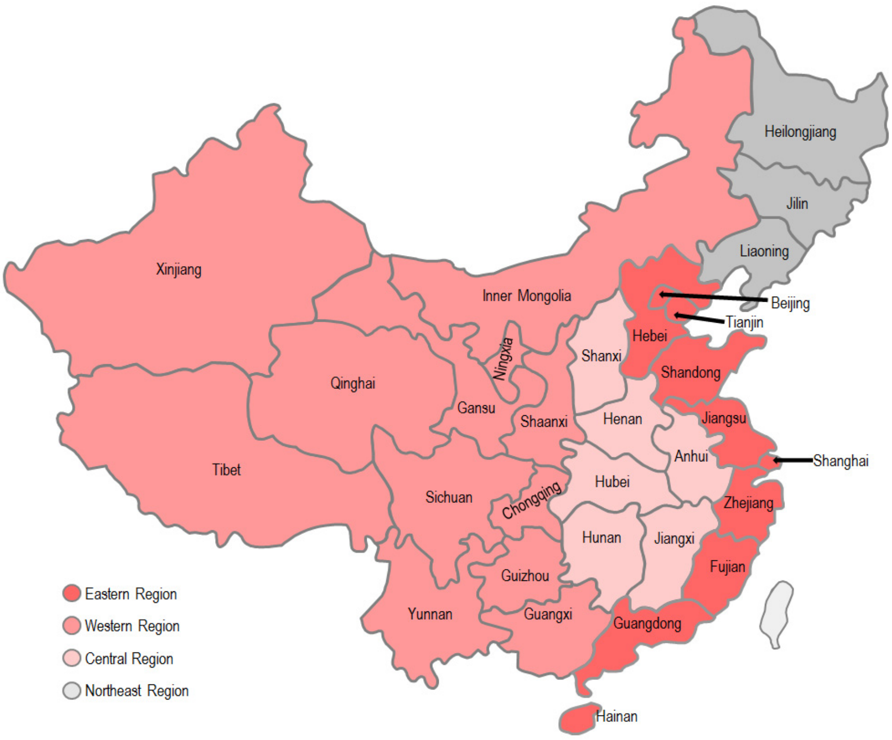
The gap between richer and poorer regions has narrowed significantly in recent years. Around the turn of the century, the richest region – Shanghai – enjoyed living standards that were around 10 times higher than those found within the poorest region – Guizhou. By 2014, the richest region's living standards – by then, Tianjin – were only four times higher than those in the poorest regions – Guizhou and Gansu. The lower ratio reflected both a slowdown in growth across the richer regions and a continuation of double-digit growth in the poorer regions.

7. The gap in living standards is closing but is still very large



Note: The calculated series is the share of minimum to maximum NGDP per capita across provinces.
Source: Chinese National Bureau of Statistics

8. China's provinces – from East to West



Source: HSBC

Still, compared with other 'single currency areas', income disparities are huge

Nevertheless, the level of income inequality across China's regions is still very large. Differences in living standards between Chinese provinces and municipalities are much greater than between the 50 states that make up the US, the 19 nations that make up the euro, the 47 prefectures that make up Japan, and the 12 regions that make up the UK. It is not a perfect comparison by any means but it is, at least, a useful way to assess the degree of convergence across Chinese provinces relative to conditions in four of the world's richest single currency areas.

Table 9 shows the results, removing those provinces, states, nations, prefectures and regions that have populations less than 1% of the total and whose inclusion would tend unreasonably to bias the results (Luxembourg's population, for example, is a mere 543,000, making it no bigger than a typical third-tier Chinese town even though it enjoys incredibly high 'first tier' living standards). For each single currency area, we have listed the richest and poorest 5 regions. We have also shown the ratio of each region relative to the richest. The results are striking. The variance in living standards in China is far greater than in the other four examples. While some parts of China may be well on the way to catching up with living standards more typically seen in the developed world, living standards elsewhere in the Middle Kingdom are still very low. In other words, China is in no way 'one economy'. Despite common ethnicity and Mandarin's status as China's official language, China is more divergent than any major developed economy or region.

9. Regional disparities in China bigger than for other major countries/regions

China (2014)					US (2014)					Eurozone (2014)				
	GDP per capita (RMB)	Relative to richest province	Population size (000s)	Share of total population		GDP per capita (USD)	Relative to richest state	Population size (000s)	Share of total population		GDP per capita (EUR)	Relative to richest state	Population size (000s)	Share of total population
Top 5														
Tianjin	105202	100	14945	1.1	New York	72480	100	19378	6.2	Ireland	53314	100	4613	1.4
Beijing	99995	95.0	21332	1.6	Connecticut	70797	97.7	3574	1.1	Netherlands	51590	96.8	16854	5.0
Shanghai	97343	92.5	24204	1.8	Massachusetts	70245	96.9	6548	2.1	Austria	51127	95.9	8534	2.5
Jiangsu	81874	77.8	79498	5.8	Texas	65540	90.4	25146	8.5	Finland	49541	92.9	5464	1.6
Zhejiang	72967	69.4	55030	4.0	Washington	63507	87.6	6725	2.2	Germany	47627	89.3	80890	23.9
Bottom 5														
Anhui	34425	32.7	60564	4.4	Florida	44675	61.6	18801	6.2	Italy	34960	65.6	61336	18.1
Guangxi	33090	31.5	47365	3.5	Arizona	44455	61.3	6392	2.1	Spain	30262	56.8	46405	13.7
Yunnan	27264	25.9	47003	3.4	Kentucky	43463	60.0	4339	1.4	Portugal	22081	41.4	10397	3.1
Gansu	26427	25.1	25865	1.9	Alabama	41726	57.6	4780	1.5	Greece	21683	40.7	10958	3.2
Guizhou	26393	25.1	35051	2.6	South Carolina	41144	56.8	4625	1.5	Slovakia	18417	34.5	5419	1.6

Source: Chinese National Bureau of Statistics, US Bureau of Economic Analysis ,World Bank

Japan (2012)					UK (2013)				
	GDP per capita (JPY 000s)	Relative to richest prefecture	Population size (000s)	Share of total population		GVA per capita (GBP)	Relative to richest region	Population size (000s)	Share of total population
Top 5									
Tokyo	4423	100	13159	10.3	London	40215	100	8472	13.2
Aichi	3437	77.7	7411	5.8	South East	25843	64.3	8821	13.7
Shizuoka	3195	72.2	3765	2.9	Scotland	21982	54.7	5337	8.3
Ibaraki	3137	70.9	2970	2.3	East of England	21897	54.4	5977	9.3
Shiga	3116	70.4	1411	1.1	South West	21163	52.6	5393	8.4
Bottom 5									
Aomori	2422	54.8	1373	1.1	East Midlands	19317	48.0	4610	7.2
Nagasaki	2400	54.3	1427	1.1	Yorkshire	19053	47.4	5353	8.3
Nara	2393	54.1	1401	1.1	Northern Ireland	17948	44.6	1836	2.9
Kagoshima	2387	54.0	1706	1.3	North East	17381	43.2	2613	4.1
Okinawa	2035	46.0	1393	1.1	Wales	16893	42.0	3093	4.8

Source: ONS, Eurostat, Statistics Japan

Special Economic Zones and Hukou

Some Chinese regions are more 'special' than others

This divergence stems in part from the development model adopted in China under Deng Xiaoping at the beginning of the 1980s. The creation of special economic zones – with a mixture of favourable tax breaks, reduced customs duties, accessibility to foreign capital, improved connections with the rest of the world and a disciplined focus on quality exports to developed markets – coincided with economic lift-off for a limited number of provinces. Table 10 shows the number of zones created within each province alongside each beneficiary's rank within those listed in table 6. Of the regions that contain special economic zones, most are now among China's top ten richest provinces.

10. Special economic zones have mostly led to special provinces

Province	No. of Special Economic Zones & Open Coastal Cities	Per capita GDP rank (out of 31)
Tianjin	1	1
Shanghai	1	3
Jiangsu	2	4
Zhejiang	2	5
Liaoning	1	7
Fujian	2	8
Guangdong	5	9
Shandong	2	10
Xinjiang	1	16
Hebei	1	18
Guangxi	1	27

Source: HSBC

Hukou system undermines the Lewis model

Yet it wasn't just a story about special economic zones. The *Hukou* system – the household registration system – also played its part, specifically by placing limits on the mobility of labour. In the so-called 'Lewis model' of economic development[1], the initial benefits of industrialisation accrue almost entirely to entrepreneurial capitalists: a huge supply of underemployed rural workers transfers to urban areas via migration but this serves only to keep urban wages as depressed as those in rural communities (where, despite a reduction in the number of workers, the overall situation of underemployment and low productivity prevails). The *Hukou* system – first established under Mao Zedong in 1951 – initially prevented migration from happening altogether. The rules were loosened in the 1980s and beyond: tens of millions of '*rural Hukou*' workers came to live and work in China's mega cities. Importantly, however, they didn't enjoy the social security, healthcare and education benefits of the '*urban Hukou*' and, in the majority of cases, they faced significant 'wage discrimination': their wages were typically between 40% and 60% lower than equivalently-productive local workers.

Put another way, during the last 35 years of rapid economic development, the *Hukou* system ensured that urban-registered workers – particularly those in the largest cities and conurbations – enjoyed wage increases well above those implied within the Lewis model while, thanks to the limitations (both official and otherwise) on opportunities for rural-registered workers, their wages remained very low. This mattered both within cities – where a two-tier labour market still operates – and, importantly, in rural provinces where there was no obvious mechanism to lift wages even as migrant workers headed to the bright lights. As a result, those provinces not containing special economic zones and largely rural in nature were left behind.

A European vision: the *Gastarbeiter*

The Turkish question

This was hardly an unprecedented result. The oddity, however, is that it took place within a country rather than between countries. Germany's '*Gastarbeiter*' arrangement – which led to a large number of Italians, Spaniards, Greeks, Turks, Moroccans, Portuguese, Tunisians, and Yugoslavians working in West Germany as 'guests' in the 1960s and 1970s – was in many ways similar to the *Hukou* system. The guest workers – the equivalent of Chinese rural workers – were expected to stay in Germany for a year or two and then return to their home country: there was no offer of political rights equivalent to those enjoyed by indigenous German citizens, who were effectively the equivalent of modern-day Chinese urban workers. Table 11 shows incomes per capita for the '*Gastarbeiter*' countries when they first joined the system in the 1950s and 1960s, their incomes in 1975 (by which time the *Gastarbeiter* arrangement had fizzled out thanks largely to the negative impact of the 1973 oil shock on the German economy)

1 See Lewis, W.A., Economic Development with unlimited supplies of labour, The Manchester School, Vol.22, Issue 2, pp 139-191, May 1954, Manchester and, finally, their incomes in 2010. Table 12, meanwhile, shows growth rates decade by decade following each country's first flirtation with the *Gastarbeiter* system.

11. Progress for some, not for all

Country	Year in which *Gastarbeiter* system started	Per capita income relative to West Germany in start year	Per capita income relative to West Germany in 1975	Per capita income relative to Germany in 2010
Italy	1955	0.72	0.88	0.90
Spain	1960	0.40	0.69	0.81
Greece	1960	0.41	0.64	0.71
Turkey	1961	0.28	0.32	0.40
Morocco	1963	0.16	0.15	0.19
Portugal	1964	0.42	0.54	0.69
Tunisia	1965	0.18	0.20	0.31
Yugoslavia	1968	0.35	0.42	0.32

Source: Maddison

12. Turkey performed poorly relative to others during and after the *Gastarbeiter* period

Country	Year in which *Gastarbeiter* system started	Average annual per capita GDP growth in first decade	Average annual per capita GDP growth in second decade	Average annual per capita GDP growth in third decade
Italy	1955	5.2	4.3	2.8
Spain	1960	7.5	3.8	2.7
Greece	1960	7.0	3.7	2.7
Turkey	1961	4.0	2.2	2.7
Morocco	1963	2.2	2.9	1.0
Portugal	1964	6.6	1.4	3.3
Tunisia	1965	4.0	2.6	1.6
Yugoslavia	1968	5.3	0.6	-2.6

Source: Maddison

The Turkish answer

Of these countries, the ones that most closely resemble China's poorest provinces are Turkey, Morocco, and Tunisia – to the extent that their incomes per capita at the beginning of the *Gastarbeiter* programme were low in relation to per capita incomes in Germany. Of these, Turkey is totally dominant: at the peak of the *Gastarbeiter* programme in the early-1970s, more than a million Turks were living in Germany, accounting for over 30% of all immigrant labour, more than any other country. Turkey's early-1960s position also closely resembles the 'rural' aspect of the Lewis development model: well over 40% of the Turkish economy was devoted to agriculture, consistent with a considerable degree of 'underemployment'. To the extent that Turkish '*gastarbeiters*' only managed to get relatively low-paid and unskilled jobs in Germany, there was little benefit to the Turkish economy if and when they went home. Given political upheavals in Turkey, many chose not to: the flow of workers was driven by political as well as economic factors.

Joining the EU broke down barriers, unleashing a period of catch-up

Spain, Greece and Portugal had significant advantages. They were richer at the outset, their populations were better educated and they therefore had less catching up to do. Later, membership of the European Economic Community (which eventually became the European Union) transformed both their access to other European markets and the institutions within which their domestic markets operated. Removal of borders in effect led to greater convergence and, by implication, a sustained period of economic catch-up relative to an already-rich Germany. Workers in the former-Yugoslavia would doubtless have made a lot more progress over the entire time period had war been avoided in the early-1990s: as it was, the war proved to be immensely costly not only in terms of lives lost and communities destroyed but also in terms of severe relative economic decline.

China's own prospects

A tale of three outcomes

The disparity in living standards between China's provinces is still very large, even if there has been some convergence over the last decade or so. Special economic zones have, for the most part, been successful. Yet, thanks in part to the *Hukou* system, other parts of China have, relatively, fallen far behind. Comparisons with other major economic areas today suggest that the degree of divergence remains unusually high, closer in scale to what typically was seen between countries while Germany's *Gastarbeiter* system was in operation.

This suggests one of three scenarios regarding China's future growth prospects.

The optimistic scenario – 'positive convergence'

The poorest regions have the most to gain

The optimistic scenario ultimately depends on China's ability to encourage convergence through catch-up. In this way, China's economy overall can continue to expand at a reasonably rapid rate, even if there is no repeat of the double-digit growth rates recorded in the pre-financial crisis years. Table 13 is illustrative, offering growth projections region-by-region over the next 15 years subject to a convergence "constraint": specifically, that the income gap between the provinces narrows to something closer in spirit to what is more typically seen in developed market, single currency areas. On the assumption that Tianjin, China's richest region, sees GDP expand at an annual rate of 3.7% while Gansu, one of its poorest regions, sees GDP growing at around 8% – and with all other regions strung out between these two extremes – then China could happily expand at a 6% annual rate through to 2030: Tianjin would make 28% less progress on incomes per capita than the average, while Guizhou would make 41% more progress than the average.

The numbers in the table are in no way forecasts. Instead, they are just a collection of constrained calculations. Nevertheless, they provide some hope for China. Even if growth in

13. China's growth chance – 'positive convergence'

Province	GDP (2014, RMB bn)	Convergence growth rate (annual average percent)	GDP (2030, RMB bn)	GDP per capita in 2030 (assuming constant population) in RMB	GDP per capita, where richest province equals 100)	GDP gain or shortfall relative to uniform 6 per cent growth rate
Tianjin	1572	3.7	2711	181428	100	-28
Beijing	2133	3.7	3678	172447	95	-28
Shanghai	2356	3.7	4063	167875	93	-28
Jiangsu	6508	4.8	13149	165411	91	-16
Zhejiang	4015	5.2	8589	156084	86	-11
Inner Mongolia	1776	5.2	3801	151971	84	-11
Liaoning	2862	5.6	6482	147636	81	-6
Fujian	2405	5.6	5447	143727	79	-6
Guangdong	6779	5.6	15351	143682	79	-6
Shandong	5492	5.6	13456	137856	76	-6
Jilin	1380	6.3	3451	125424	69	4
Chongqing	1426	6.3	3566	119664	66	4
Hubei	6558	6.3	6842	117825	65	4
Shaanxi	1768	6.3	4423	117335	65	4
Xinjiang	926	6.8	2485	108935	60	12
Hunan	2704	6.8	7256	108077	60	12
Hebei	2942	6.8	7892	107624	59	12
Heilongjiang	1503	6.8	4034	105231	58	12
Sichuan	2853	7.2	8097	99672	55	18
Shanxi	1275	7.0	3520	96742	53	15
Henan	3493	7.0	9639	96036	53	15
Jiangxi	1570	7.0	4334	95627	53	15
Anhui	2084	7.0	5752	94977	52	15
Guangxi	1567	7.0	4324	91295	50	15
Yunnan	1281	8.0	4065	86483	48	32
Gansu	683	8.0	2168	83830	46	32
Guizhou	925	8.5	3133	89384	49	41

Source: Chinese National Bureau of Statistics, HSBC calculations the richer areas is now harder to come by than it once was, the possibility of continued catch-up in the poorer areas implies that, for China as a whole, the pace of economic expansion could remain relatively robust, at least when compared with countries and regions elsewhere.

How might this convergence best be achieved? First, the abandonment of the *Hukou* system – alongside efforts to get rid of informal discrimination – would transform the Chinese labour market. And, according to Beijing, the system is supposed to be phased out by 2020 (although time will tell). There would be a cost for the successful coastal regions – in terms of a significant slowdown in wage growth thanks to greater competition from rural workers – but the benefit at the national level would come from a more efficiently-employed workforce. Second, and fully consistent with the abandonment of the *Hukou* system, opportunities for 'learning by doing' would eventually encourage not only labour to head to the more prosperous regions but also capital to go to the poorer regions (in the same way that Polish workers have migrated to Germany even as German capital had migrated to Poland). Third – and in line with Beijing's '*One Belt, One Road*' strategy – China's infrastructure linkages to the rest of the world should increasingly be based not on sea routes across the Pacific and into the Indian Ocean but, instead, on land routes through the Central Asian republics into Europe, thereby recreating the original Silk Road. This would boost opportunities for some of China's poorer inland provinces.

The 'status quo' scenario: stalled *Hukou* reform

The European Single Market model

As with the optimistic scenario, growth in China's richest regions slows down but, rather than reflecting a 'rotation' to 'catch-up' areas as a consequence of a 'Germany-Poland' integration, the slower pace of expansion simply stems from an unwinding of earlier excessive investment and associated financial strains. This economic setback, in turn, places political limitations on the ultimate degree of *Hukou* reform, thereby limiting the degree of both labour and capital mobility. As a result, potential productivity gains fail to materialise leaving aggregate economic growth averaging well below 6% over the next 15 years.

In many ways, this would be a Chinese version of failures to deliver a properly-functioning Single Market within the European Union. Opportunities abound but a desire on behalf of richer areas to avoid potential losses and an unwillingness of capital to move to poorer areas leads to an absence of labour market integration, in turn leaving some regions persistently poorer than others. It could be a repeat of the differences between northern and southern Italy on the grandest of scales.

The pessimistic scenario – 'convergence from above'

The austerity danger

The pessimistic scenario might more accurately be described as 'convergence from above' rather than 'convergence from below'. The gap between richer and poorer provinces closes thanks to a collapse in activity in the richer provinces, triggered by the discovery that much of the investment seen particularly in the aftermath of the financial crisis was ultimately wasteful. A severe loss of revenues leads to the cancellation of infrastructure projects that had promised a lifeline to China's poorer provinces. Silk Road opportunities are placed on hold. China enters a sustained period of much lower growth, similar to the disappointments Japan suffered in the 1990s and beyond.

Which scenario is most likely?

As we argued at the beginning of this note, comparisons with Japan are far from perfect. There are plenty of cyclical similarities but China is at a fundamentally different stage of economic development than Japan was in the 1980s. China still has a lot of catching up to do. As a result – and notwithstanding high financial volatility since the 'renminbi wobble' in August 2015 – the pessimistic scenario seems to be the least plausible, at least when thinking about the next 15 years. There will doubtless be ups and downs along the way but there is no obvious reason to believe that China will no longer be able to expand any faster than countries in the developed world.

14. The opportunities – and challenges – lie to the West

Source: HSBC

This leaves a choice between the 'optimistic' and 'status quo' scenarios. There can be no doubt that Beijing's policymakers will want to avoid the status quo scenario. The risks of political and social instability would be higher under this scenario simply because the gap between rich and poor would be 'hard-wired' into the Chinese economy, leaving regional imbalances bigger than anything on offer in other large 'single currency' regions. Yet the success of the optimistic scenario depends on stability not only within China but also in the countries to its west (chart 14). Those 'western' countries include, amongst others, Pakistan, Afghanistan, Iran, Iraq and Syria, not best known for their predictable political arrangements. Any 21st Century Silk Road might fare better in states further north – in keeping with the original Silk Road – including most obviously those already members of the Shanghai Cooperation Organisation – Kazakhstan, Kyrgyzstan, Tajikistan, Uzbekistan and Russia[2]. The optimistic scenario is certainly possible but – unlike China's earlier stages of development – its achievement will depend increasingly on China's international statecraft and the behaviour of states over which it has no control. It will not be easy.

It helps to have good neighbours

2 India and Pakistan are due to accede, Afghanistan, Belarus, Iran and Mongolia have 'observer status' while Armenia, Azerbaijan, Cambodia, Nepal, Sri Lanka and Turkey are 'dialogue partners'

Disclosure appendix

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