CHINA ECONOMICS UPDATE

Answers to your questions on China's slowdown

- **Challenges to China's long-run growth potential that were mounting a few years ago are now evident to all. We continue to expect trend growth to have fallen to around 2% in 2030.**
- We held an online drop-in yesterday to discuss how our views on China's outlook have evolved since we published a *Focus* report five years ago in which we first detailed this long-run view. The recording from yesterday can be viewed here. In this note we summarise our answers to your questions during the drop-in, including some we didn't have time for in the live event. (This week's Chief Economist's Note from Neil Shearing also revisits the original analysis.)
- ***How have your views changed since 2018?*** Looking back, the 2018 *Focus* did a good job identifying the main constraints to growth and how they were mounting faster than was generally thought at the time. Our analysis showed that the investment-intensive growth model was faltering, with major challenges looming in the property sector in particular. We pointed to an increasing role of the state and the Party in economic decisions as a growing drag on productivity. And we argued that an important constraint on China's ability to follow the path that rapidly led other successful Asian economies to high income was that major trading partners would push back against further increases in China's share of global export markets. In the decade after it reached the level of income that China was at in 2018, Japan doubled its share of global exports. That wasn't going to be possible for China.
- **But there are a few things that look different today. One is that the demographic picture turned out to be worse than we knew in 2018 – and productivity better**. We thought that employment was near a peak. In fact, revisions in the 2020 census showed that employment had already peaked in 2014.
- The census revisions did not materially shift our projections for the pace at which the working age population will be declining at the end of this decade. But they brightened the outlook for productivity: If employment was lower than we had thought in 2018, output per worker – or productivity – must have been higher since we hadn't changed our estimate of the size of the economy. In other words, **productivity growth in 2018 was not slowing as rapidly as we had thought**.
- **Set against this positive shift have been offsetting developments suggesting that headwinds to future productivity growth have strengthened. One was the pandemic**. The messy collapse of zero-COVID controls at the end of last year may have dented confidence. But the leadership's overall verdict seems to be that China's early successes and its lower mortality rate overall demonstrate the value of centralised decision-making and a willingness to use the full power of the state to pursue the resulting policy goals. Economic theory and the evidence of the past decade both suggest that this approach will hamper productivity gains.
- **Another development that has pushed state intervention further than we had anticipated is the breakdown in relations with the West**. We had expected that trading partners would try to limit China's exports – as indeed the Trump administration soon did by escalating tariffs on shipments from China later in 2018. But the controls that the US subsequently imposed on access to technology have gone well beyond trying to cap China's export market share.
- These controls have worsened the growth outlook in two ways: directly, by preventing Chinese firms from adopting technology; and indirectly by giving more urgency to existing efforts within China to increase self-

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sufficiency. Even if these efforts succeed, they will do so by redirecting resources that could have been used more productively if allocated by market signals.

- ***Are the risks to your long-term forecasts skewed to the upside or downside?*** We are still comfortable with our forecast of 2% trend growth in 2030. Although this still puts us below most forecasters' expectations (though less so than five years ago), we don't believe that this is a particularly downbeat forecast. It implies that that per capita incomes in China will continue to converge with developed economy incomes. (China's aggregate GDP might not because of the drag of a contracting population.) Our 2% forecast would place China in the middle of the ranks of middle-income EMs: no longer an outperformer, but not an underperformer either. A substantially stronger outturn would require a shift in China's policy framework (see below). A weaker outturn could be the result of a financial crisis (unlikely in our view) or a significant deterioration in geopolitical relations.

- ***How do demographics affect China's potential growth?*** Demographics contribute much less to the GDP growth slowdown that we expect over the rest of this decade than decelerating productivity. By the early 2030s, the population aged 15-64 is likely to be contracting by about 0.6% each year, compared with a 0.1% contraction in 2023. We think that over the same period trend GDP growth will fall from 4-5% to 2%. But the half percentage point drag from demographics could be the difference between China continuing to catch up with the US economy and its catch-up stalling in the 2030s.

- ***How big a part does property play in the slowdown? Does Japan's property crash offer lessons for China?*** Although property downturns are often the trigger for financial crises, that risk is mitigated in China in two ways: first, prices don't appear in need of a major correction: the problem is excess leverage and overbuilding by developers rather than unsustainable prices; second, state control of the financial system gives capacity to manage the resolution of debt problems gradually. The flipside though is that, as in Japan in the 1990s, bad debts take a long time to be resolved, and badly-indebted companies are able to continue operating, preventing resources (employees, land, credit) migrating to where they could be better used.

- And however developer debt strains are resolved, construction activity will inevitably be weaker in future. Residential construction was contributing one percentage point to growth until recently. For the rest of this decade, it is likely to be contracting.

- ***What could China's leadership do to achieve faster growth?*** In many ways, in China's rise to middle income it followed a similar path to Japan, Korea and Taiwan. They also provide models of middle income economies with manufacturing prowess that rapidly rose to high income. But we argued in the 2018 note that China wouldn't be able to continue emulating them. China had run ahead of these earlier Asian successes in its expansion of domestic investment and global market share and had less room to continue in the same way. Crucially too, it does not appear that China's leadership *wants* to follow their path, which involved economic liberalisation that, in Korea and Taiwan, was coupled with political liberalisation. Instead, the Party is reasserting its control in many areas: that strongly suggests that strong economic growth is not the leadership's primary goal. Weaker growth is not the result of ineffective policy but a trade-off China's leaders appear willing to accept.

- ***Should global investors avoid China in future?*** China's financial markets will continue to offer short-term opportunities. But the recent raids on foreign firms in China, even as officials have been trying to reassure foreign investors that China is "open for business", underline the degree to which the business landscape has shifted. And tail-risks – of being unable to repatriate investments or having them seized – appear much larger than a few years ago.

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