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GLOBAL MACRO RESEARCH

CHINA: POTENTIAL GROWTH – LOWER FOR LONGER

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BNY MELLON | INVESTMENT MANAGEMENT

WE CONTINUE TO HAVE A BEARISH VIEW FOR CHINESE GROWTH OVER THE MEDIUM TERM RELATIVE TO CURRENT MARKET EXPECTATIONS. OUR BASE CASE IS THAT THE POTENTIAL GROWTH RATE OF CHINA FALLS OVER THE NEXT FIVE YEARS BEFORE PLATEAUING AT AROUND 2.5% FROM 2028 ONWARDS. WE HIGHLIGHT THE KEY FACTORS THAT UNDERPIN THIS BELIEF AND WHY WE BELIEVE THE RISKS ARE SKEWED TO THE DOWNSIDE.

EXECUTIVE SUMMARY

- When we assess the drivers of potential growth over recent decades, three of the four key inputs are now in decline: capital, labour, and total factor productivity.
- In our base case scenario, the potential rate of growth declines more rapidly than market forecasters expect before stabilising at around 2.5% from 2028 onwards. In our view, the challenges of rebalancing the growth model, containing the negative spill-overs from property-sector weakness, and deleveraging the broader economy are all likely to be greater than commonly believed.
- We outline four reasons we believe the decline in potential growth will continue.
  - Political priorities have shifted away from growth alone
  - Demographics are now a serious problem
  - Managing the property sector decline is a long-term challenge
  - High levels of leverage raise the risk of a balance-sheet recession
- Our analysis suggests that the greatest impact from slower potential growth in China will be felt by countries within the same regional sphere – most notably Australia, Malaysia, Singapore, Korea, Thailand and Vietnam.
- If policymakers do successfully manage to rebalance the economic model, there are also likely to be net winners amongst those countries with the greatest exposure to Chinese household consumption.

ASSESSING THE OUTLOOK FOR POTENTIAL GROWTH

BREAKING DOWN THE DRIVERS OF POTENTIAL GROWTH

To assess China's growth potential, we first need to identify the key factors that have driven potential growth over recent decades so that we can assess how each is evolving. When we do this, we find that there are four key inputs, and three of them are in decline:

- **Capital:** A key driver of growth during the investment and export-led growth model pursued from 2001 when China joined the World Trade Organization. As policymakers attempt to rebalance the economic model from being investment-led to consumption-led, the rate of investment is set to decline, weighing heavily on potential growth. High levels of leverage are an additional headwind, as further increases in debt are highly targeted.
- **Labour:** Demographic decline has become a structural problem for China since 2012. The impact is expected to worsen in the decade ahead, reducing potential growth by between 0.5% to 1% per annum. No other country has faced such a rapid deterioration in demographics as China, and it is the first major developing country to face this challenge.
- **Total factor productivity:** When China became the low-cost manufacturing hub for the world it had a significant competitive advantage, and both capital and labour could be put to work in an efficient manner – boosting potential growth. These easy wins are now behind us, and future investments are unlikely to be as productive as in the past.
- **Human capital:** The only factor to remain positive is human capital, as education levels and health should continue to improve as economic development continues, but the impact is small.

WE SEE THREE POTENTIAL SCENARIOS AHEAD

After our assessment of the key drivers of potential growth, we have constructed three broad scenarios for the future and evaluate these relative to market expectations[1] in Figure 1.

In our view, the critical determinant of which scenario will prove correct will be how successful policymakers are in rebalancing growth from a model driven by investment and exports to one driven by consumption. The consensus among market forecasters is for potential growth to decline gradually by 0.2% to 0.3% per annum, reducing the potential growth rate from current levels of 4.5% to 5% to around 3% by 2030. This is primarily driven by structurally falling capital input.

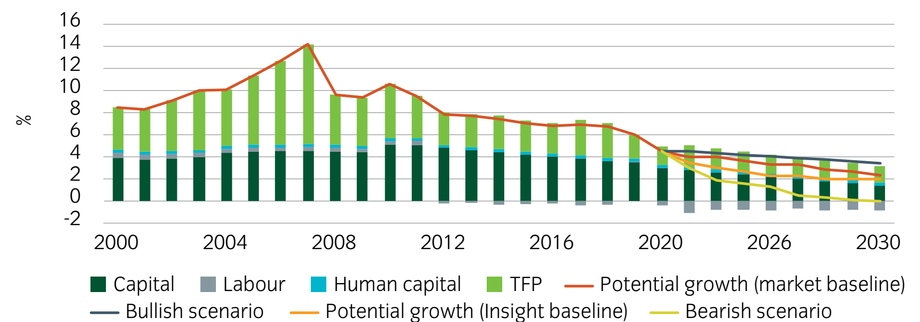
- **Scenario 1 – Insight's base case:** The potential rate of growth declines more rapidly than market forecasters expect before stabilising at around 2.5% from 2028 onwards. In our view, the challenges of rebalancing the growth model, containing the negative spill-overs from property-sector weakness and deleveraging the broader economy are all likely to be greater than commonly believed. We have previously outlined why we hold this view in our paper 'Is China in a balance sheet recession?'.
- **Scenario 2 – Bullish case:** If policymakers are able to rebalance the growth model more quickly than expected then a more bullish scenario would emerge. Key to this would be broad-based reforms of the Hukou system which entitles Chinese citizens to benefits such as healthcare or education, as a greater social safety net would reduce the need for households to retain such high savings. If policymakers were able to successfully manage the slowdown in the property sector and engineer a broader economic deleveraging, this would further underpin a more optimistic outlook.

[1] The market baseline is constructed from IMF forecasts and sell-side institutions' expectations for medium-term growth rates in China.

- **Scenario 3 – Bearish case:** If policymakers lose control of the property sector and a crash spills over into the broader economy, the impact could be significant. Local government financing vehicles and investment trusts linked to the property sector could start to default and the blow to business and household confidence could become irreparable. This would have the potential to trigger a balance-sheet recession, where debt repayment was prioritised above all else. If social stability became challenged, the actions of the Chinese state could become less predictable, and growth might be entirely sacrificed in pursuit of maintaining control.

When constructing these scenarios, it is notable that optimism needs a range of policies to come to fruition, whereas pessimism needs control to be lost in one area. The level of state intervention within the economy is sufficiently high that success is not impossible, but it is hard for us not to conclude that the risks lie to the downside.

Figure 1: China potential GDP growth by factor and our scenarios versus market consensus[2]



FOUR REASONS WE BELIEVE POTENTIAL GROWTH WILL CONTINUE TO DECLINE

1 POLITICAL PRIORITIES HAVE SHIFTED AWAY FROM GROWTH ALONE

There is a recognition amongst policymakers that they need to rebalance the economic model, and themes such as dual circulation and common prosperity are now a high priority. This is a significant change from the previous decade where growth maximisation was an unquestioned policy priority, and credit expansion the policy of choice to achieve it. Policy is now more targeted, with credit directed to strategically important, highly productive sectors of the economy such as high-tech manufacturing, green-energy transformation and chipmaking. Less productive sectors with high levels of debt such as the property sector have clearly been deprioritised.

Rebalancing the economy from an investment-led model to a consumption-led model carries significant execution risks. The pivot away from sectors that previously drove growth must be carefully managed, and the sectors that will replace them must be identified and nurtured. This must all be done against a backdrop of deglobalisation, and with anti-China policies being enacted in several countries that were previously key trading partners.

[2] Source: IMF, Wind, Barclays Research. Data as at 31 December 2023, and data for 2023 and beyond is a forecast. Bars for 2023 and beyond are forecasts for the makeup of the market baseline. 2021-22 is removed given impact of Covid pandemic.

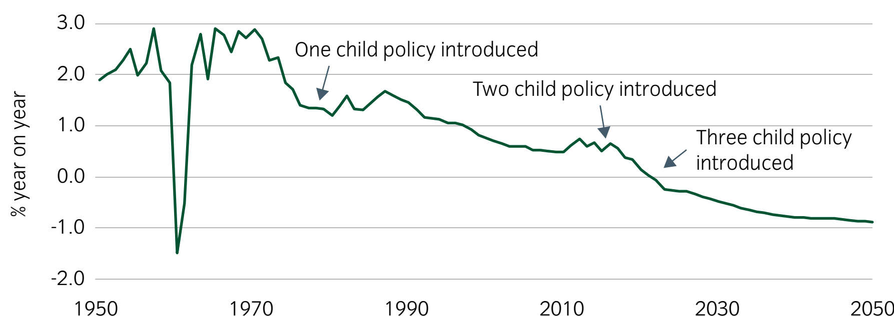
We have yet to see a country with a similar political model to China ascend from developing to developed status, and policymakers will need to be careful to escape the middle-income trap[3]. Regulation and oversight are increasing as the state pursues its policy goals and this has become problematic for several sectors, including property, technology, education, and gaming. This has weighed on equity markets, which have significantly underperformed their international counterparts.

For investors, assessing how the transition is progressing has become increasingly challenging. Policymakers have simply stopped publishing granular detail on economic performance as growth has slowed – with the most recent example the publication of youth unemployment data.

2 DEMOGRAPHICS ARE NOW A SERIOUS PROBLEM

The consequences of the one-child policy, introduced decades ago, are now increasingly apparent and will remain a drag on growth for the foreseeable future. The population is now shrinking and, despite more recent policies to encourage larger families, the rate of decline is forecast to accelerate for decades ahead (see Figure 2). Although this could potentially be countered by increasing migration, this appears an unlikely solution given the scale that would be needed.

Figure 2: China's population is already in decline, and it's going to get worse[4]



3 MANAGING THE PROPERTY SECTOR DECLINE IS A LONG-TERM CHALLENGE

The demographic outlook has structurally changed the demand for housing over the longer-term, and policymakers are now faced with carefully managing a slowdown in a sector that was previously a key driver of growth.

Although the construction industry itself accounts for around 7.1% of China's GDP, when you include the output from other associated sectors the contribution rises to 24.5% of GDP. Of this, 6.8% is classified as infrastructure/other construction – which has typically been used by policymakers as a counter-cyclical policy tool. In aggregate, real-estate construction accounts for around 17.7% of final demand within the economy, approaching 23% to 24% of GDP when including real-estate services (e.g., leasing and maintenance of buildings).

These are huge numbers that impact a broad range of economic agents. Households are exposed via wealth and confidence, corporates via asset values and direct or indirect exposure to the industry; and local governments heavily relied on land sales for fiscal revenue. Losing control of the slowdown is a key risk for the Chinese Communist Party as it has the potential to drive social unrest, and this means continued intervention is likely for years to come. Each intervention requires capital to be used in an unproductive way, preventing it from being directed into those areas of the economy that will provide long-term growth.

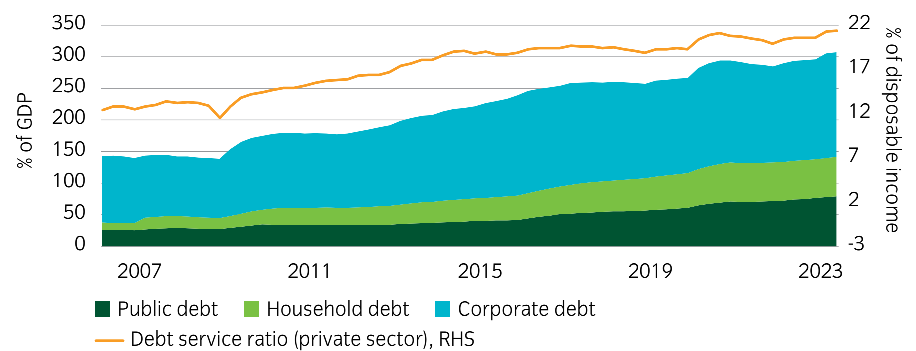
[3] The middle-income trap is where a middle-income economy finds that it can no longer compete on labour intensive goods as wages have become too high, but is also unable to compete in higher value-added sectors as productivity is too low.
[4] Source: Macrobond. Data as at 31 December 2023, data for 2023 and beyond are forecasts.

4 HIGH LEVELS OF LEVERAGE RAISE THE RISK OF A BALANCE-SHEET RECESSION

Aggregate leverage in China is already at advanced-economy levels at around 300% GDP (see Figure 3) with most of the leverage concentrated in the corporate and local government sectors. Structurally high leverage and weaker growth prospects exacerbate the risk of a balance-sheet recession, where economic agents start to prioritise debt repayments over economic growth. Balance-sheet recessions typically mean a prolonged period of sub-trend growth where conventional monetary policy tools become less effective as there is no desire to increase leverage or take more risk. The troubled property sector, falling asset values, deteriorating demographics, financial imbalances, the level of leverage, structurally weaker growth prospects and low external debt are all factors which lead some to make comparisons between China and Japan.

The huge level of intervention that the state plays in the economy and strict capital controls are key differences, however, and combined with a lower level of development and continued urbanisation allow policymakers to better manage, and potentially even resolve, these problems.

Figure 3: China's economic leverage has grown[5]



[5] Source: Macrobond, BIS (The Bank for International Settlements) as at 15 August 2023.

CONCLUSION

Policymakers are faced with a difficult path ahead and, in our view, this skews the risks to the downside. The economy must be rebalanced away from an investment-driven model which has led to the country's high debt burden. If policymakers kick the can down the road, they simply continue along an unsustainable path and make an eventual rebalancing even more painful. There is no precedent to what China is attempting to do given the scale of its economy and its unusual political structure. South Korea and Japan have undergone significant transformations from high-investment economies, but in both cases the transition has taken considerable time and neither country was quite as reliant on investment as China.

The ability of the government to forcefully intervene at both an economic and corporate level could prove to be critical in pushing the transition through, but ideological constraints and a fragile social balance mean it is in no way guaranteed. The People's Bank of China also faces a careful balancing act in the years ahead. Policy must be kept sufficiently easy to support growth and encourage consumption, but financing needs to be carefully directed – prioritising productive sectors, but also keeping unproductive sectors afloat.

IMPLICATIONS FOR THE REST OF WORLD

Trade is not the only channel by which structurally slower Chinese growth would impact the rest of the world, but it is likely to be the largest and one of the more straightforward gauges to model. Clearly, the more a country is exposed to China via trade (relative to its GDP), the more disproportionately it is likely to be impacted if China slows more rapidly than markets expect. We set out potential winners and losers in Figure 4. Our analysis suggests that the greatest impact will be felt by countries within the same regional sphere – most notably Australia, Malaysia, Singapore, Korea, Thailand and Vietnam. Countries exposed to the old investment-driven model are likely to be the greatest losers. However, if policymakers do successfully manage to rebalance the economic model, then there are also likely to be net winners amongst countries with the greatest exposure to Chinese household consumption.

Figure 4: Potential winners and losers[6]

Winners	Losers
• Countries with exposure to Chinas growing status as end consumer products • Products where import substitution more difficult • Those who benefit from other countries continuing to diversify supply chains out of China	• Import substitution and promoting self-sufficiency likely to have negative impact on external sector in long term relative to current dynamic • Malaysia, South Korea and Singapore likely to be most affected given key products exported to China • China to become competitor in third markets as it gains new capabilities. 5G / data centres / AI / new energy vehicles • Raw materials exporters to China – Australia, Brazil, Chile, New Zealand • Semiconductor exporters to China – Korea

[6] Source: Insight, for illustrative purposes only.

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