Focus

China's continuing growth slowdown

- *China's era of rapid economic growth dated from 1979 until about a decade ago.*
- *Main drivers were rapid growth in the working-age population, increased participation, employment, longer working hours and rapid productivity growth.*
- *However over the past decade all four drivers have slowed.*
- *Moreover the first three seem almost certain to continue to detract from overall growth.*
- *And the fourth seems unlikely to re-accelerate sufficiently to offset this.*

A 'structural' slowing in economic growth has been in train for some time

As a matter of arithmetic (not economic theory), the growth rate of a country's real GDP is determined by the growth rate of its population, the change in the proportion of the population who are employed, the change in the average number of hours worked by those who are employed, and the output of goods and services per hour worked by those who are employed.

Formally:

$$\Delta Y = (\Delta P) \times \Delta(N/P) \times \Delta(H/N) \times \Delta(Y/H)$$

where Y is GDP, P is population, N is employment, and H is hours worked – so that N/P is the employment-to-population ratio, H/N is average hours worked, and Y/H is labour productivity.

The 4 factors that drove China's growth from 1979 to 2010 …

China's rapid growth (of 10% per year, on average) between 1979 and 2010 was – as depicted in Figures 1 and 2 – the result of:

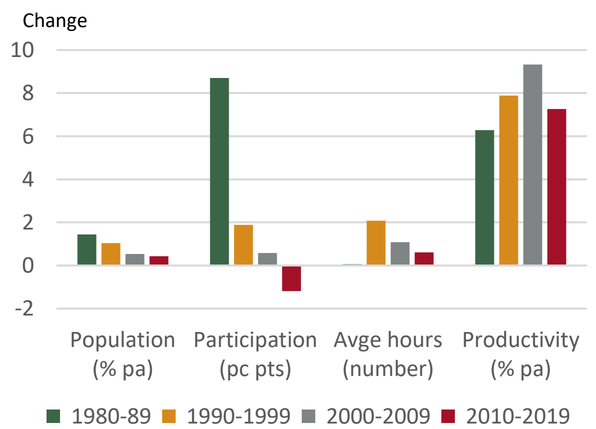
- Fairly rapid growth in its population, averaging 1.4% per year up until 1995, after which it slowed to 0.5% per year between 2000 and 2010;
- An increase in the employment-population ratio of almost 11 percentage points (from 47.4% in 1979 to 58% in the middle years of the first decade of this century);
- An increase in average hours worked from 37.9 per week in 1979 to 41.8 per week by 2010; and
- Growth in labour productivity averaging 7.9% per year over the entire period.[1]

… all slowed during the decade leading up to the pandemic

Over the past decade, however, China's economic growth rate has slowed – to an average of 7¼% per year between 2010 and 2019 (i.e., before the onset of Covid-19):

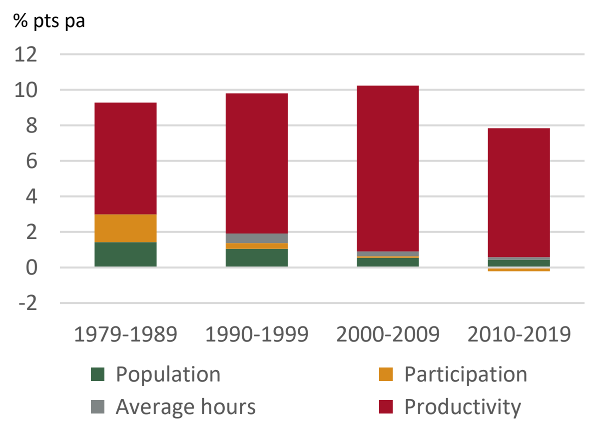
- The growth of the population has continued to slow, to 0.3% per year towards the end of the decade;
- The employment-to-population ratio has declined, by 1.8 percentage points from its peak in 2004-07 to 56.6% by 2019 (largely reflecting the increasing proportion of the population who are now retired).

Figure 1: Drivers of Chinese real GDP growth, 1979-2019



Sources: The Conference Board, Corinna Economic Advisory

Figure 2: Contributions to Chinese GDP growth, 1979-2019



Sources: The Conference Board, Corinna Economic Advisory

- Average hours worked have remained stable, at around 41.8 per week; and
- Growth in labour productivity has slowed, from over 8% per year at the beginning of the decade to an average of 6½% per year between 2017 and 2019 inclusive.

The short-but-sharp recession induced by the onset of Covid-19 in the first quarter of last year, the subsequent rebound in economic activity in the middle of last year, and the subsequent ebbs and flows associated with virus outbreaks, natural disasters and power shortages thus far during 2021 complicate the interpretation of these metrics over the past two years.

And at least 3 of them will continue to do so this coming decade

However, it seems highly probable that at least three of them will continue to damp China's *potential* long-term growth rate over the next decade (and beyond):

- The most recent United Nations demographic projections suggest that the growth rate of China's population will continue to decline until the population peaks in 2029, and that thereafter the population itself will start to decline (something which recent changes to China's 'one-child' policy may eventually slow, but will not reverse).[2]
- The employment-to-population ratio seems highly likely to continue to decline, given that the 'working-age' population (i.e., those aged 15-64) as a proportion of the total, which peaked at 73.8% in 2010 and declined by 3.4 percentage points over the ensuing decade, is expected to decline by a further 2.8 percentage points over the coming decade; and
- For the same reason, average hours worked are unlikely to increase (not having done so over the past 15 years) and may well decline – especially given increasing public antipathy and regulatory hostility towards the so-called '996 culture' (working from 9am to 9pm, six days per week).

Whether China can sustain economic growth at the (slower) rate which it achieved during the 2010s therefore depends on whether it can *reverse* the slow-down in productivity growth which occurred over the decade between the global financial crisis and the onset of Covid-19. The argument here is that, although not impossible, this is an unlikely prospect. Rather, it seems more plausible that productivity growth in China will continue to slow, and possibly by a larger margin than it did during the 2010s.

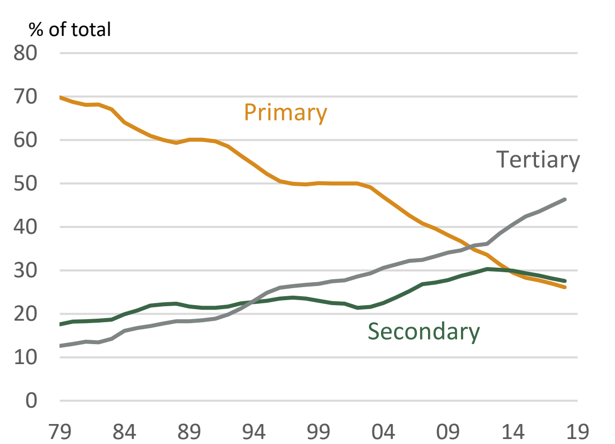
W(h)ither structural change?

A major contributor to the sustained rapid growth in labour productivity that China has attained over the past four decades has come from the movement of 'factors of production' (labour, capital and land) out of subsistence agriculture into manufacturing and services.

Structural change has been a big driver of productivity …

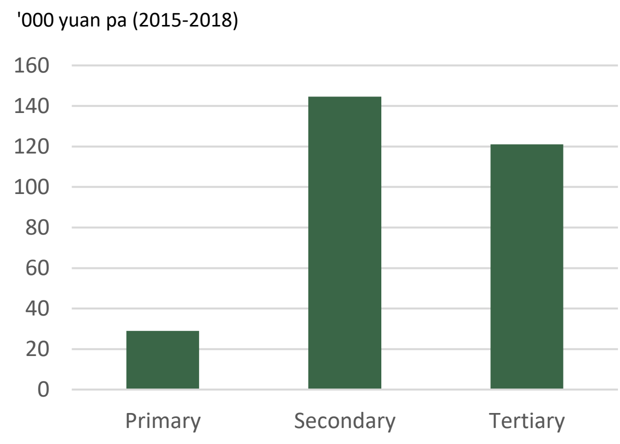
Although labour productivity (measured, unavoidably crudely, by GDP per person employed) in Chinese agriculture has improved dramatically over the past 40 years, it has always been less than one-quarter (and usually less than one-fifth) of that in manufacturing. So the decline over this period in the proportion of China's workforce employed in primary industry, from 70% in 1979 to 26% in 2018 – and the corresponding increase in the proportion employed in secondary and

Figure 3: Sectoral composition of employment in China



Source: China National Bureau of Statistics

Figure 4: GDP per person employed, by sector, 2015-18



Sources: China National Bureau of Statistics, Corinna Economic Advisory tertiary industries from 18% to 28%, and from 12% to 46%, respectively, has been a crucial factor in China's ability to sustain its extraordinarily rapid rate of economic growth for so long (Figure 3).

… but the pace of structural change has begun to slow

However, the scope for further reductions in agriculture's share of economic activity and employment is now much more limited. Moreover, manufacturing's share of GDP peaked at around the time of the global financial crisis, and its share of total employment in the early 2010s. Almost 60% of the growth in China's GDP over the decade to 2019 came from the tertiary sector.

And because labour productivity in services is about 16% lower than that in manufacturing (see Figure 4), the likely continued growth in services as a share of total economic activity will (all else being equal) detract from overall productivity growth.

Two recent developments seem likely to drag on productivity growth over the coming decade.

China is scaling back its reliance on trade and investment …

The first is the new 'Dual Circulation Strategy' first laid out by China's President Xi Jinping in May last year and formally adopted as part of the 14th Five Year Plan at the National People's Congress in February.[3] This strategy explicitly seeks to reduce China's reliance on international trade and investment as drivers of economic growth (while still remaining open to both), instead fostering growth in domestic demand and supply.

The shift in emphasis is partly a response to the deteriorating bilateral political and economic relationships between China and the US – with a particular aim of reducing China's dependence on US technologies. And China is hardly alone in reconsidering the 'strategic' risks posed by global supply chains in the wake of the pandemic. But in China, no less than in other countries, the pursuit of 'security' or 'resilience' in preference to 'efficiency' is almost certain to entail some cost in terms of productivity.

It is also partly a recognition of the fact that, with China now accounting for almost 15% of total world merchandise exports, compared with less than 1% in 1979 and less than 4% even as recently as 2000, the rest of the world simply cannot absorb growth in Chinese exports at the rates it has over the past three or four decades.

… and its regulatory crackdown too is likely to damp growth

The second risk arises from China's regulatory 'crackdown' on important parts of the services sector, including e-commerce, financial services, gaming, and private education, as part of a greater emphasis on reducing inequality and promoting 'common prosperity'.[4]

While efforts to reduce inequality need not detract (and indeed can enhance) overall economic growth,[5] the particular nature of China's regulatory crackdown has already resulted in significant dislocation of the targeted sectors,[6] and may well reduce the pace of innovation and hence productivity growth.

A farewell to leverage

Leverage supported demand growth after the financial crisis …

China's ability to sustain economic growth after the global financial crisis at a pace which, though slower than over the previous three decades, was still much more rapid than almost every other economy in the world, was also facilitated to no small degree by a significant increase in financial leverage.

Total credit outstanding rose from 140% of China's GDP in the second half of 2008 to almost 290% of GDP in the second half of 2020 – a higher figure than for any of the other emerging market economies for which the Bank for International Settlements maintains comparable data, and only about 10 pc points below the average for 'advanced' economies (Figure 6).

More than half of that debt (equivalent to about 160% of GDP) is owed by non-financial corporations (and within that, a large proportion is owed by state-owned enterprises to state-owned banks).

Corporate sector leverage actually peaked in 2016, immediately after the financial crisis of 2015-16, which saw the People's Bank of China (PBoC) use one-fifth of its reserves in a (successful) attempt to defend the renminbi (Figure 5).

… but for five years the authorities have been clamping down on this

In the aftermath of that episode, China's monetary authorities sought to clamp down on 'shadow banking', in particular, and property-oriented leverage more generally.[7]

In August last year the PBoC and the Ministry of Housing imposed new regulations (known as "the three red lines") limiting debt to assets, net debt to equity, and cash to short term borrowings of property development companies to 70%, 100% and 1, respectively (these are the regulations of which China Evergrande has fallen foul, raising profound concerns about its viability). These form part of a broader determination to rein in China's real estate 'bubbles', in line with Xi Jinping's insistence that "houses are for living in, not for speculation". As a result, property investment has been making a much smaller contribution to overall GDP growth in recent years than prior to 2015, and that is unlikely to change in the years ahead.

China has stimulated less than any other large economy

It is particularly notable that, unlike every 'advanced' economy and almost every other 'emerging or developing' economy, China has neither cut interest rates nor embarked on any wide-ranging 'unorthodox' monetary policy measures in order to support economic growth. On the contrary, the People's Bank of China has prided itself on having "adhered to implementing a normal monetary policy" and eschewing the "elixir" that "central bank purchasing of assets … can spur the economy without causing higher inflation".[8] China's fiscal policy response to Covid-19 has also been smaller (as a proportion of GDP) than in nearly all 'advanced' economies and in other large 'emerging' economies.[9]

Conclusion

China is no longer capable of sustaining the double-digit growth in real GDP that it did between 1979 and the global financial crisis. And, unlike in the years immediately after the global financial crisis, China's authorities are fully aware of that.

Under Xi Jinping they are pursuing a range of economic (and political) objectives – and maximizing GDP growth is not one of them.

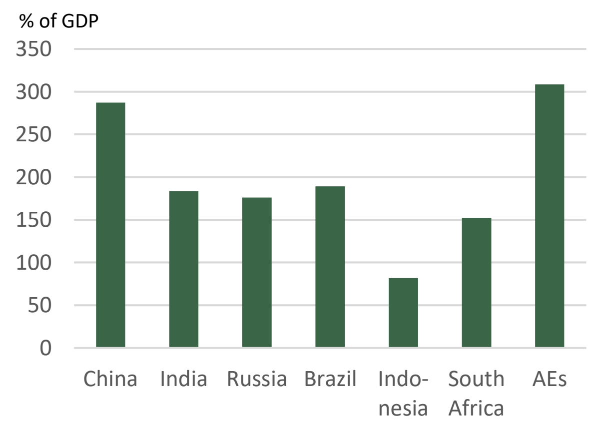
This shift will likely be formalized at the Sixth Plenum of the 19th Chinese Communist Party Congress to be held from 8th-11th November, at which (for only the third time) it will adopt a 'Resolution on History'. This will mark the official end of the Deng Xiaoping era of 'Reform and Opening Up' (which began with the last 'Resolution on History' in June 1981).

China's growth is likely to continue on a slowing trend.

Watch fors

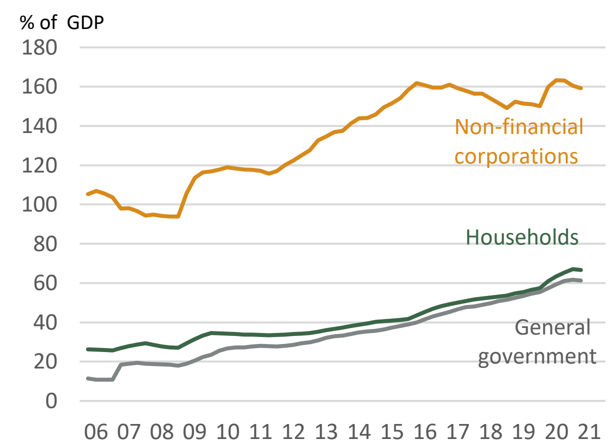
- Any pronounced deviation in growth trends in data series that are less readily 'smoothed' than real GDP – including production of major items, credit, and international trade.
- Any abrupt changes in PBoC policies (which will not be decided independently by the PBoC).
- Any extension (or, alternatively, relaxation) of the more assertive stance taken by specific industry regulators.
- Any major deterioration (or, alternatively, improvement) in bilateral relations with the US.■

Figure 5: Credit to non-financial sectors, as of 31 March 2021



Source: Bank for International Settlements

Figure 6: Credit as a proportion of GDP by sector, 31 March 2021



Source: Bank for International Settlements

End notes

[1] These figures, and those in the following paragraph, are derived from the Conference Board's Total Economy Database (August 2021 edition), using the 'official' series for real GDP.

[2] See United Nations Department of Economic and Social Affairs, *2019 Revision of World Population Prospects*.

[3] See e.g. Alessandro Bazzoli, 'China's Plan for the Post-Pandemic World Order: The Dual Circulation Strategy', *Global Risks Insights*, 30 April 2021; or Lin Justin Yufu and Xiaobing Wang, 'Dual Circulation: a New Structural Economics view of development', *Journal of Chinese Economic and Business Studies*, 4 June 2021.

[4] For an official explanation, replete with references to 'strengthening the "four consciousnesses", firming the "four self-confidences" and achieving "two maintenances"', see 'The Central Committee of the Communist Party of China (CPC) and the State Council issued the outline for the implementation of the construction of a government under the rule of law (2021-2025)', *Xinhuanet*, 11 August 2021. This document commits to, among many other things, "strengthen[ing] law enforcement in key areas related to the vital interests of the masses, such as food and medicine, public health, natural resources, ecological environment, safe production, labour security, urban management, transportation, financial services, education and training".

[5] See e.g. Federico Cingano, *Trends in Income Inequality and its Impact on Economic Growth*, OECD Social, Employment and Migration Working Papers No. 163, Paris, 9 December 2014; and Era Dabla-Norris, Kalpana Kocchar, Nujin Suphaphiphat, Frantisek Ricka and Evridiki Tsounta *Causes and Consequences of Income Inequality: A Global Perspective*, IMF Staff Discussion Note 15/03, International Monetary Fund, Washington DC, June 2015.

[6] Lily Kuo, 'Xi Jinping's crackdown on everything is remaking Chinese society', *Washington Post*, 9 September 2021.

[7] See e.g. Guo Shuqing (Chairman of the China Banking and Insurance Regulatory Commission), 'Unswervingly Fight the Critical Battle of Preventing and Defusing Financial Risks', *Qiushi*, People's Bank of China, Beijing, 26 August 2020.

[8] People's Bank of China, Monetary Policy Report Q2 2021, Beijing, 9 August 2021, pp. 3 and 16; 'China adopts normal monetary policy as long as possible: central bank governor', *Xinhuanet*, 11 October 2020.

[9] IMF, *Fiscal Monitor Database of Country Fiscal Measures in Response to the COVID-19 Pandemic*, Washington DC, July 2021.