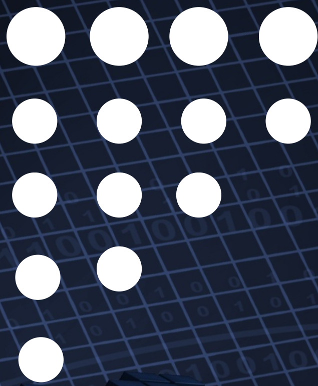


EMERGING MARKETS FORUM

BACKGROUND PAPER

COULD "JAPANIFICATION" HOLD CHINA BACK?

Could “Japanification” Hold China Back?

Centennial Asia Advisors, June 2024

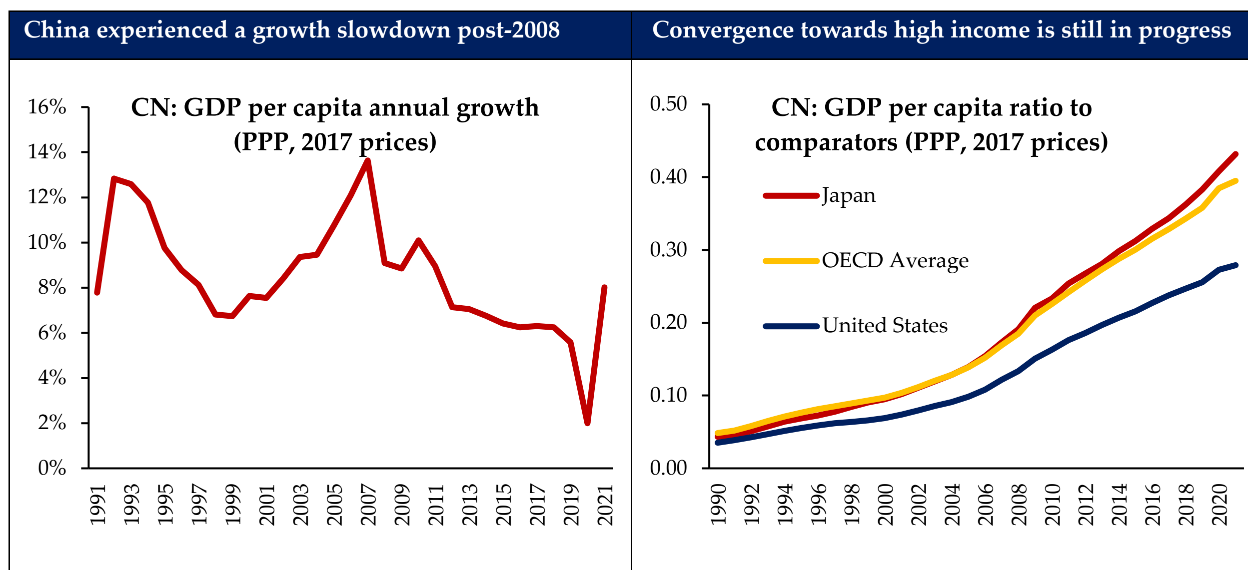
China’s growth performance in the post-COVID period has been disappointing, with potent short-term difficulties from the botched re-opening, policy mismanagement, and geopolitical tensions casting a shadow on the near-term growth prospects. Taking a longer-term view, we argue that the structural headwinds are equally, if not more, formidable. While such comparisons are necessarily incomplete, China’s economic fundamentals compare unfavourably compared to the experience of other East Asian tigers. The prospect of “Japanification”, which we loosely define as structurally-induced economic stagnation, is a realistic one. This paper proceeds as follows:

- Section 1 argues that China’s admirable growth performance in earlier years was from leveraging “low-hanging” fruits of growth, including from the Deng era liberalizations and the WTO accession. We further suggest that these are starting to run out of steam and that the period of the Chinese economy growing at high rates on a sustained basis is likely over.
- Section 2 delves into three structural factors that are the cause of our worries for China’s long-run growth potential, namely population, productivity, and investments. Far from being an “economic miracle”, China enters this new phase of its development on a weaker footing than other East Asian economies when they were making the transition towards high-income status. The global environment, characterised by geopolitical tensions, economic “de-risking” and concerns over its massive industrial overcapacity, also means that the path available to the Asian tigers is less accessible to China today.
- Section 3 presents our views on what policy reforms may provide the Chinese economy with a renewed lease on vitality. These include affecting a rebalancing of the economy from investments towards consumption, and deeper microeconomic reform including major liberalization of the hukou system. However, expectations for such reform need to be managed in light of the formidable political and economic barriers.

The key takeaway from our analysis is not that China is doomed to low or mediocre growth. Nor is it that there are no more pockets of dynamism in specific sectors or markets that may yield productive investment opportunities. Our argument is a structural one; the pre-COVID era of high, sustained growth is well and truly over. Without the right policy responses, the possibility of China joining Japan in facing a period of economic stagnation should be taken seriously.

SECTION 1: THE CHINESE GROWTH MIRACLE HAD TO END SOMETIME

China's rapid transition from an economy ravaged by the disastrous policies of Mao Zedong to one of the world's top two economies (depending on the metric chosen) is undoubtedly the most impessive economic development achievement in recent history. The liberalizing reforms associated with the late paramount leader Deng Xiaping and the consequent participation in world export markets, to name just two factors among many, allowed China to sustain strong growth rates above 8% for decades. Even the slower post-2008 growth performance was still respectable by international standards. Consequently, per-capita income in China rose from barely 5% of advanced economies to a respectable 40% within a short span of 30 years. The accompanying gains in human welfare, measured by reduced mortality increased lifespan and quality of life, and the virtual elimination of extreme poverty, have also been admirable.



Source: Centennial Asia Advisors calculations based on World Bank Open Data

Such high growth rates could not be sustained indefinitely so it was not surprising that China experienced slower growth after the 2008 financial crisis. The economic dynamics that lead to developed economies growing at slower rates have started to apply to China as the low-hanging fruits of growth are gradually exhausted[1]:

- The gains from undoing the most egregious distortions under Mao administration policy were essentially one-off; the high growth observed was thus a natural consequence of depressed growth being undone
- Diminishing returns to capital accumulation as further investments into machinery, infrastructure, and other physical capital yield smaller marginal gains in output
- Relatedly, the gains from technological catchup are gradually eroded, as the economy transitions towards the more difficult task of indigenous technological innovation

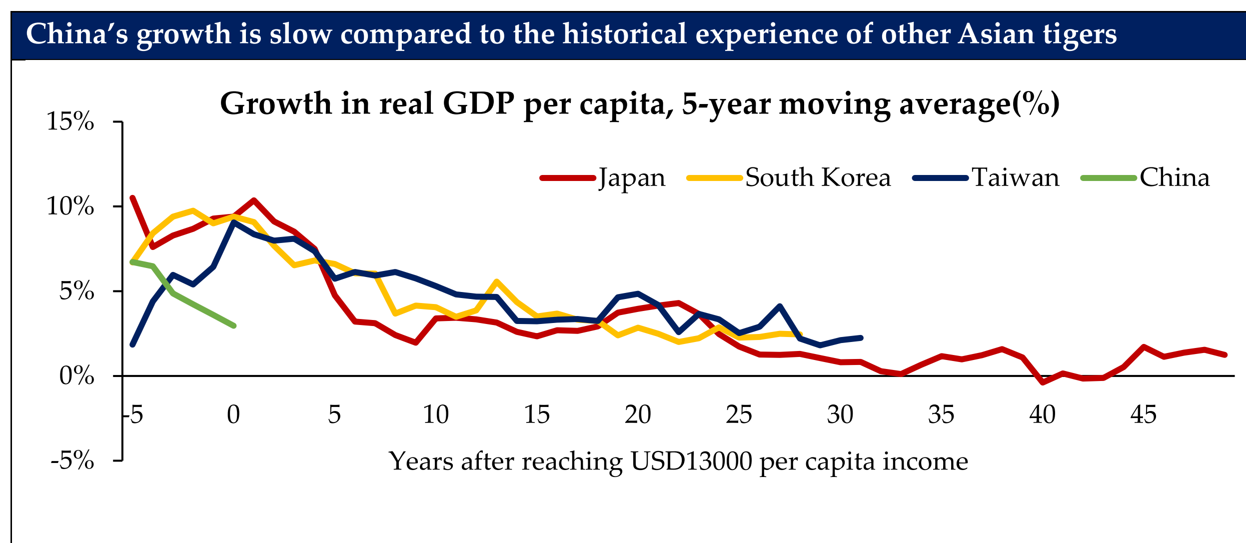
The growth experience of China's high-income neighbours clearly illustrates this point. After reaching real per-capita incomes of USD13000 (China's income level in 2018), medium-run

[1] Rodrik (2011) *The Future of Economic Convergence*

growth in the "tiger economies" of Japan, South Korea, and Taiwan slowed down from the high-single digits to less than 5% within two decades, even if there may be individual years that record high growth. The phenomenon is not merely confined to Asian economies: once-fast-growing middle-income countries tend to experience slower growth once per-capita incomes reach the USD12500-13750 range[2].

The international experience thus suggests that even under "normal" circumstances, China's economy was bound for slower medium-run growth. What is noteworthy, however, is that China enters this stage already with significantly lower growth rates; its "Asian Tiger" neighbours enjoyed a few more years of strong growth after reaching this threshold before the slowdown became pronounced. By contrast, medium-run per capita income growth, adjusted for inflation, dipped below the 3% mark in the years preceding 2018. The setbacks inflicted by COVID-19 are only likely to render the picture more unfavourable.

China's growth is slow compared to the historical experience of other Asian tigers



Source: Centennial Asia Advisors calculations based on Maddison Project Database

There are good reasons to believe that much of the potential gains associated with earlier stages of catchup growth have been exhausted.

Consider, for instance, industrialization-led structural change, where a larger proportion of the economy shifts away from primary industries such as agriculture and other commodities towards higher-value-added activities in manufacturing. Some indicators point to China already beginning the process of de-industrialization; the share of employment in the industrial sector peaked in 2012 and has slightly dipped in the decade since, while the industrial share of GDP has also displayed a similar trend. There may be more de-industrializing to come given the trends in its domestic economy, as well as shifts in global economics and geopolitics as rising costs and a more hostile trade environment spur a relocation of global supply chains away from China.[3]

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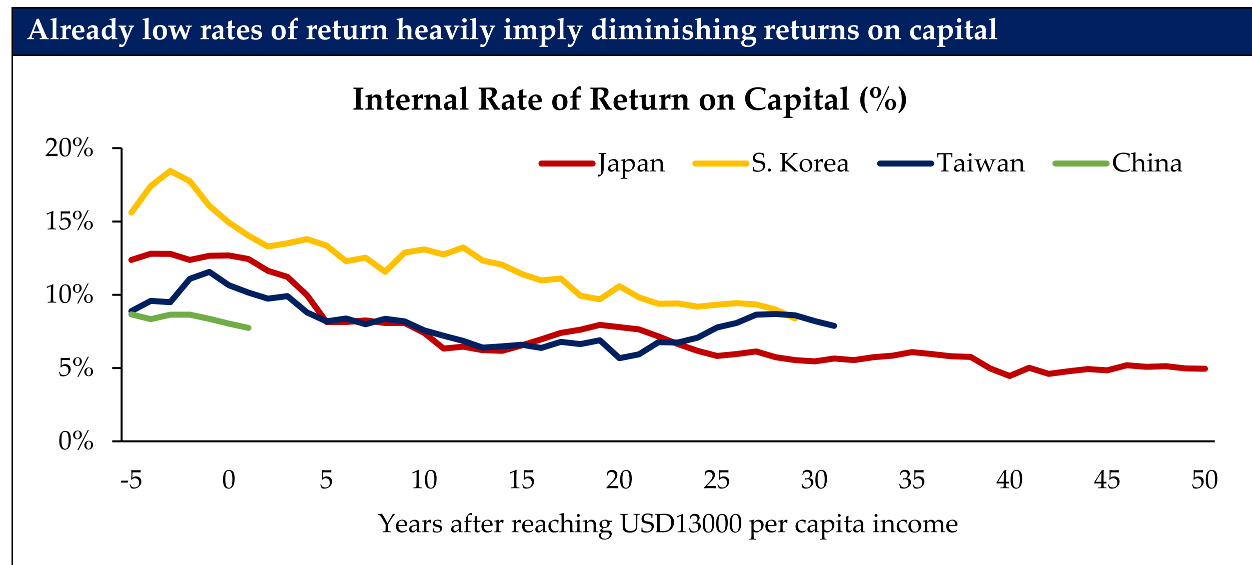
[2]Eichengreen, Park, and Shin (2014) *Growth Slowdowns Redux: New Evidence on the Middle Income Trap*

[3] Lovely (2021) *The State of US-China Relations Heading into 2021*

Another aspect of this is the aftereffects of China's investment-led growth model. After the global financial crisis and the exhaustion of earlier reforms led to a secular decline in productivity growth, policymakers in Beijing attempted to make up the shortfall with a large investment push in business (including state-owned enterprises), housing, and public capital. The former helped keep overall growth rates afloat, but diminishing returns meant that the marginal output gains from further investment would likely be lower.

Support for this view comes from the Penn World Table's estimate of internal rates of return on capital, which attributes the output excluding labour income and resource rents to the capital stock.[4] Rates of return rose in the Deng era, peaking in 1995 at around 14% before declining to its current level of around 8%. This is similar to South Korea and Taiwan today except that the latter enjoy much higher levels of income. Even Japan was able to maintain higher rates of capital return after reaching the income threshold before its "lost decades". For China to reach this lower rate of return at a much earlier stage of development suggests that investments have been over-relied on as a driver of previous growth, and cannot be counted on for continued long-run growth.

Already low rates of return heavily imply diminishing returns on capital



Source: Centennial Asia Advisors calculations based on Penn World Tables

These are but two of the most salient signs that the era of China easily achieving growth rates of over 6% is likely over. However, there remains a question of what would be the "new normal" for Chinese growth moving forward. There is no consensus on this issue yet; some have argued that growth for the 2020-2030 decade can still average out at around 5.0%, including the World Bank's outlook. More bearish views, including by the IMF, see Chinese growth slowing down to 3.5% or even lower by the end of the decade due to the difficulties of the post-pandemic period and also a geopolitical environment that will be less conducive to strong growth rates.

In our view, the underlying fundamentals of the Chinese economy place it in a worse position than the "East Asian" miracles which are facing structurally slower growth. In other words, China may be facing "Japanification" on steroids.

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[4] Inklaar and Woltjer (2019) *The Penn World Tables 9.1*

SECTION 2: CHINA ENTERS THIS NEW PHASE WITH WEAKER FUNDAMENTALS

The regular dynamics of transitioning from a lower-income to a middle-income economy meant that China was bound to experience a degree of slower growth, just as its East Asian neighbours did in their earlier stage of development. However, we argue that China is entering this new phase with weaker economic fundamentals than its peers, suggesting that it may struggle to even match the performance of Japan, South Korea, and Taiwan in their respective growth trajectories.

Demographic decline: Getting old before getting rich

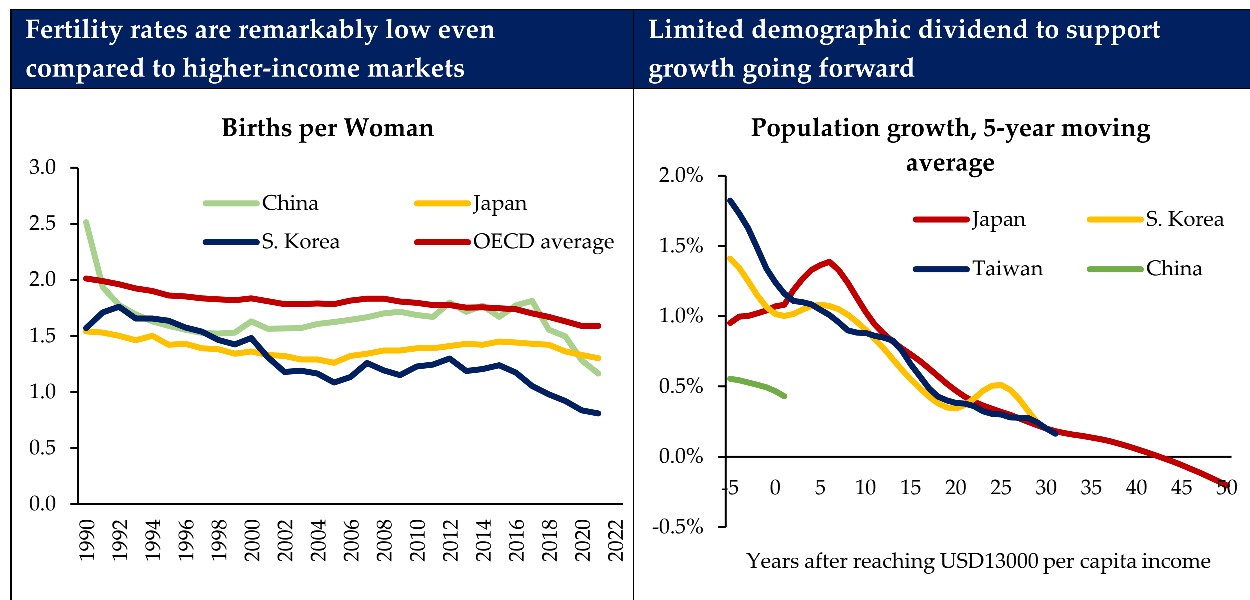
The first-order problem facing China's economic prospects is its unfavourable demographics. While population ageing is a common challenge facing most of the world's high-income economies, China is having to face this at a much earlier stage of development. Much of this is self-inflicted; the scarring effects of the one-child policy and other policy missteps mean that the population is poised to age and shrink rapidly in the coming decades.

The headline statistics in this aspect are dire indeed:

- Births per woman are estimated at 1.2 as of 2021, already lower than Japan, long-regarded as a textbook example of demographic-induced stagnation. This is also close to only half of the "replacement rate" of 2.1. Similarly, the crude birth rate stood at 6.8 births per 1,000 people, significantly lower than the OECD average of 11 births per 1,000 people.
- Consequently, the size of the overall population and labour force is expected to shrink, and by some estimates has already begun to shrink. For instance, the working-age population (15-64 years old) was estimated to have peaked in 2015 and has been on a downward trend since. The gross population growth rate has also been at a feeble 0.5% since 2017, and this is projected to decline precipitously in the coming decades due to the skew in China's population pyramid.

Taking a comparative perspective with its higher-income neighbours, Japan, South Korea, and Taiwan could still count on some demographic dividend when they were at China's current levels of income; they only experienced low population growth rates of 0.5% (China's current population growth rate) 15-20 years after hitting the income threshold. Given China's lower starting point and worse expected trajectory, the population drag and its effects on economic growth will likely be more severe.

It is not obvious that there is much scope for policy; given its massive population, China cannot realistically rely on immigration in the same way that small-to-medium-sized markets can to supplement their indigenous populations. Neither are domestic policies such as raising the retirement age or incentivizing childbearing likely to move the needle sufficiently to halt the demographic decline in any economically significant way, even if the one-off gains, however modest, may buy some additional time for other reforms to take place.



Source: Centennial Asia Advisors calculations based on World Bank Open Data (Left) and Penn World Tables (Right)

A much-needed boost in productivity is not forthcoming either

The typical way to offset the growth drags from demography is to increase per-capita productivity so that more can be achieved with the shrinking labour pool. While productivity growth in earlier periods could be attained by the pro-market microeconomic reforms, those opportunities have largely been exhausted (with some exceptions we will discuss later), and the economy now needs to attain productivity growth via the typical way of improving its efficiency and innovative capacity. In other words, China needs to step up its efforts to innovate indigenously, rather than rely on importing and copying technology from elsewhere.

On the surface, China has many advantages, some of it recently developed, that should be able to deliver on productivity growth:

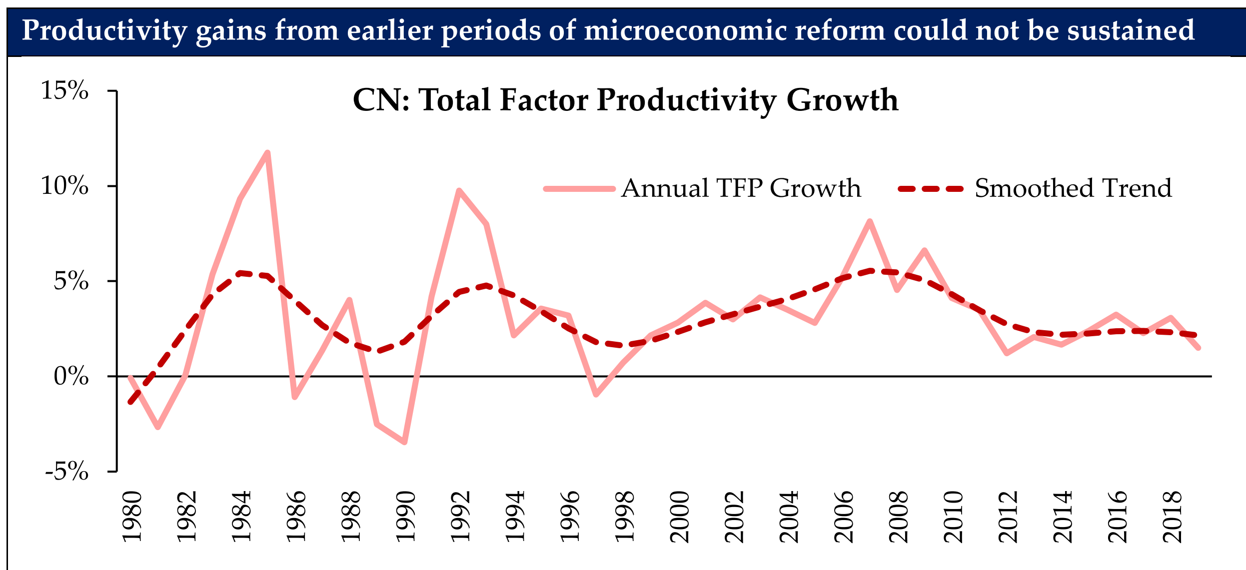
- China's still-enormous market provides it with formidable benefits from scale, networks, and agglomeration. The potential domestic consumer market, combined with a relatively well-educated workforce, has created formidable clusters of new-economy activity such as the "Greater Bay Area" of Hong Kong – Shenzhen – Guangzhou, metropolitan Beijing, and Shanghai-Suzhou. The country now exceeds the United States in terms of the number of science and technology clusters as of 2023.[5]
- The innovation ecosystem is also a boon; China ranks 11th on the Global Innovation Index, driven by advantages in technology infrastructure, business sophistication, and knowledge and technology outputs. It hosts universities that, by some measures, are credible rivals to their Western peers and recipient of considerable state largesse to bolster their research capacities. For instance, China now hosts four universities in the top 50 according to the QS rankings, it had none a decade ago.

[5] World Intellectual Property Organization (2023) *Science and Technology Cluster Rankings*

- It is possible that artificial intelligence (AI), robotics and other innovations might one day help China offset its demographic disadvantage by improving productivity sharply. Certainly China has shown itself to be a world leader in some of these fields. China accounted for 52% of global robot installations in 2022. China is also now a leader in publications and patents related to AI. However, successfully utilising these technologies to raise productivity would require a supportive eco-system and the discussion below raises doubts as to this.

Despite the potential that these factors offer, productivity growth in China has been on a downtrend, even as its innovative capabilities have expanded as enumerated above. The historical data show that China's bursts of high productivity growth occurred during the period of opening up and internal reform, where the binding policy constraints to growth were loosened. The economy's accession to the WTO also allowed a period of renewed productivity growth both due to the scale effects of a larger external market, and the inflow of foreign capital, technology, and know-how. This came to a halt after the 2008 crisis. Productivity growth has been lacklustre since.

Productivity gains from earlier periods of microeconomic reform could not be sustained



Source: Centennial Asia Advisors calculations based on Penn World Tables

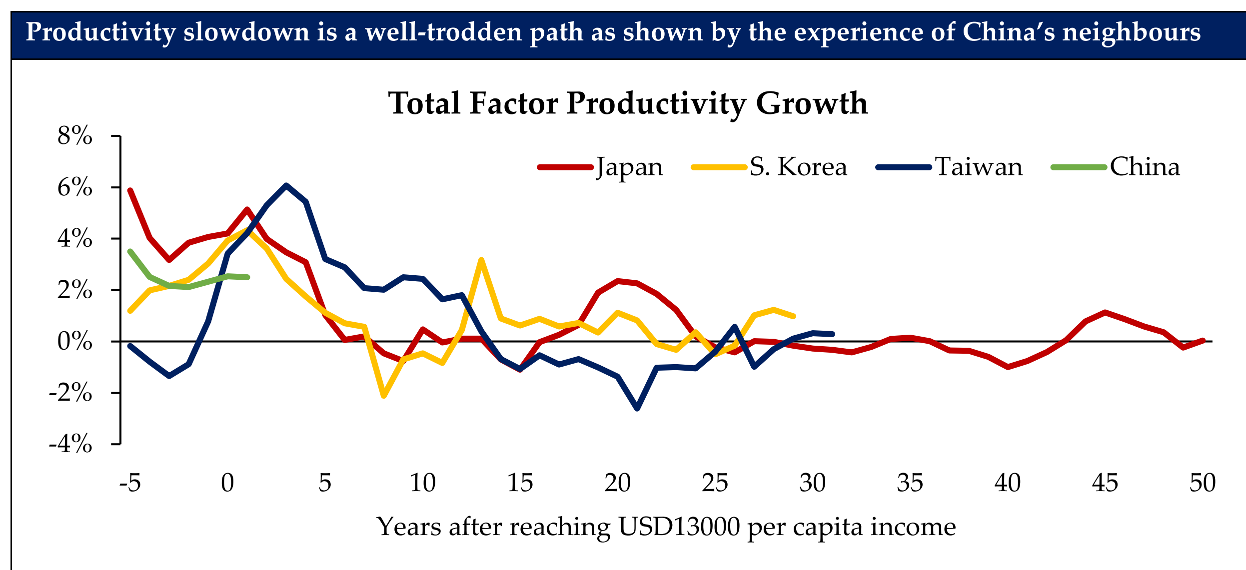
A comparison of China's performance with its East Asian neighbours at their earlier stages of development also suggests that far from being an "economic miracle", China's productivity growth is broadly in line, and by some estimates even an underperformance[6], relative to its East Asian peers. In the run-up to achieving China's current levels of income, the other Asian economies (with the slight exception of Taiwan) experienced similar or higher levels of productivity growth but experienced a significant slowdown within a decade of reaching the threshold. Japan, South Korea, and Taiwan are no slouches when it comes to science and technology, also possessing some of China's advantages such as strong universities and world-

[6] One study showed that productivity growth in China in recent years is similar to other advanced Asian economies despite its lower level of development, which should, in theory, provide it with scope for rapid catch-up growth. See Rajah and Leng (2023) *Revising Down the Rise of China*

leading firms in a wide range of knowledge-based industries. These, however, did not prevent them from experiencing a slump in productivity growth.

We further note that these data do not yet capture the possible damage inflicted by geopolitical tensions and domestic policy since the 2020s; it is hard to imagine that the regulatory crackdowns on the private sector (most notably against tech giant Alibaba), nor the restrictions on cross-border technology transfer and research exchanges imposed by Washington and its allies, will be conducive for China's long-run innovation capacity.

Productivity slowdown is a well-trodden path as shown by the experience of China's neighbours



Source: Centennial Asia Advisors calculations based on Penn World Tables

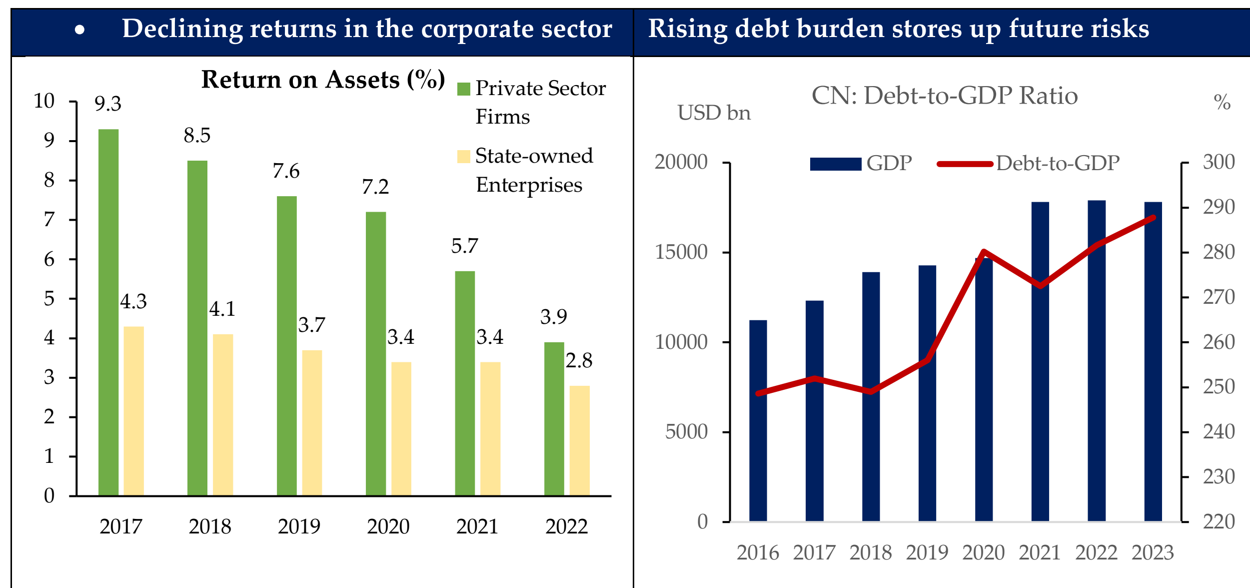
The overreliance on investments will start to bite

To maintain respectable growth rates in the face of declining productivity growth, Beijing embarked on an investment-heavy strategy in public infrastructure, business capital (via state-owned enterprises) and most notably in the real estate sector. In the aftermath of the Global Financial Crisis, excessive credit was expanded to property developers while mortgage and downpayment requirements were substantially eased for homebuyers, many of whom turned to real estate investments as a workaround for the persistently low depositor rates at the same time as massive urbanisation led to additional housing demand. The increase in Chinese household incomes and the decline in interest rates over the 2010s further contributed to households' debt-servicing ability..

These developments then manifested in one of the highest investment-to-GDP ratios among major economies, even when compared with emerging economies where capital formation plays a larger role in growth compared to consumption-oriented advanced markets. While the high level of investments in and of itself is not a problem per se, there are downsides to such a strategy that China has shown signs of mismanaging:

- As elaborated earlier, capital accumulation is subject to diminishing returns. We earlier presented an estimate of the internal rate of return and showed that it has been on a downtrend over the long term. The return on assets for Chinese corporations has also

declined across both private and state-owned sectors, suggesting a declining efficiency in investments. Meanwhile, the costs of depreciation means that a portion of assets will start becoming economically unviable due to the net negative returns.[7] This is starting to manifest in areas such as excess industrial sectors, under-utilized public infrastructure, or the now-infamous vacant real estate projects.



Source: Left: Garcia-Herrero (2023) *Can Chinese Growth Defy Gravity*; Right: *CEIC, National Institution for Finance and Development*

- The increasingly lopsided distribution of investments between private and public sector firms is further worsening already low returns on capital. Recent years have seen private investment growth plummeting as private businesses become wary of an increasingly difficult economic and political environment, with robust public investments by state-owned enterprises (SOEs) plugging the gap. However, with easy access to bank credit, the lack of a hard budget constraint in SOES gives rise to inefficiencies that result in weak returns on investments.

- Relatedly, the debt burden on the Chinese economy has been rising as assets built using prior debt struggle to pay for themselves in light of the lower returns. The debt-to-GDP ratio has been on an upward trend and is now close to 300% of GDP, driven by a combination of slower growth and still-high debt growth as Beijing continued its debt-fuelled infrastructure drive. Even if high debt is not the focal cause for current concern, it nonetheless acts as a source of potential financial vulnerability in the future.

- Crucially, while China's household debt-to-GDP ratio has remained significantly smaller than advanced economies, the meagre fraction of Chinese household incomes as a share of GDP means that household debt level as a proportion of household income is now similar to the pre-crisis US level. Furthermore, when debt is used to fund non-productive

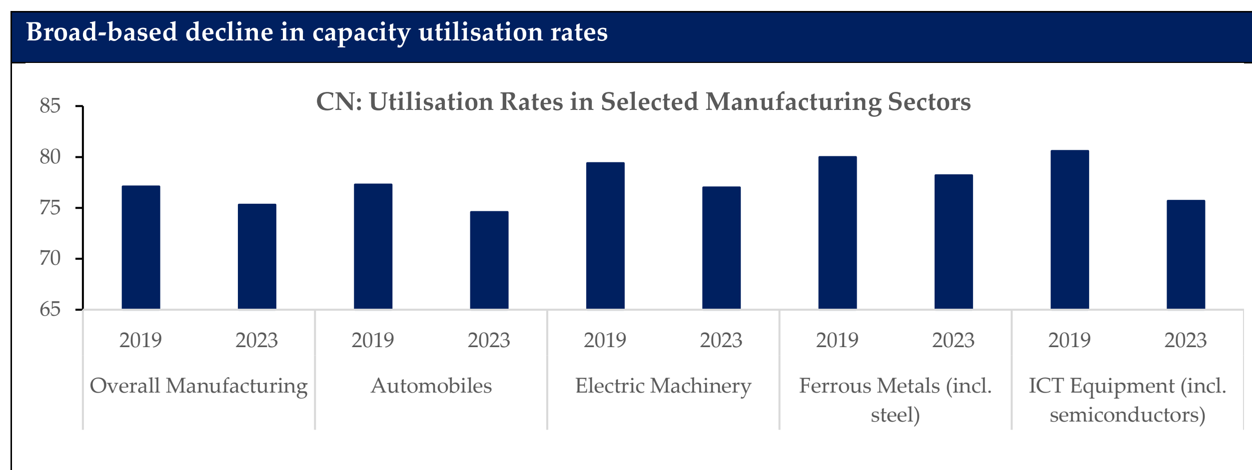
[7] There is a further argument that Chinese statistical authorities do not properly account for the write-down of non-productive investments, hence overestimating economic value-add. There are broader questions on the integrity of China's economic data which we set aside for now. Pettis (2020) *China's Economy Needs Institutional Reform Rather than Additional Capital Deepening.*

> assets (such as housing in the case of China), debt rises faster than the economy's debt-servicing capacity, which is proxied by GDP. This further explains why years of Chinese overinvestment in housing projects that contributed less to the economy than they cost has resulted in a sharp increase in its debt-to-GDP ratio[8].

A breakdown of investment into its components – namely, housing, infrastructure and manufacturing – also shows how investment growth is poised to slow, thereby contributing less to potential growth.

First, housing investment is entering a structural decline. Granted, the ongoing property slump escalating into a systemic meltdown is improbable given that most major Chinese banks are under state control and can thus provide cash infusions to developers as a last resort. Yet, policymakers will be wary that state rescue has the unintended consequence of encouraging moral hazard among developers and only serves to kick the can further down the road. As has been the case in recent years, policymakers will thus persevere in reining in the bubbly property sector. This prevents beleaguered developers, including even the state-backed ones, from having sufficient liquidity to complete sold but unfinished apartments, depressing prices and confidence among prospective buyers. Coupled with demographic decline and slowing urbanisation, slower housing investment growth is thus all but certain. As housing sales slump, this will worsen the financial stress of local government financial vehicles as they are no longer able to rely on land sales to developers to generate fiscal revenues

Second, infrastructure investment growth cannot continue at its current rate due to diminishing returns and depreciation. Increasingly, manufacturing investments will also be curtailed by the resurgence of overcapacity concerns. The combination of an aggressive industrial strategy singularly focused on achieving self-reliance in critical supply chains, cut-throat competition in the Chinese market that pressures firms to expand production to attain economies of scale, and weak domestic demand has resulted in a broad-based fall in capacity utilisation rates between pre-pandemic 2019 and 2023.



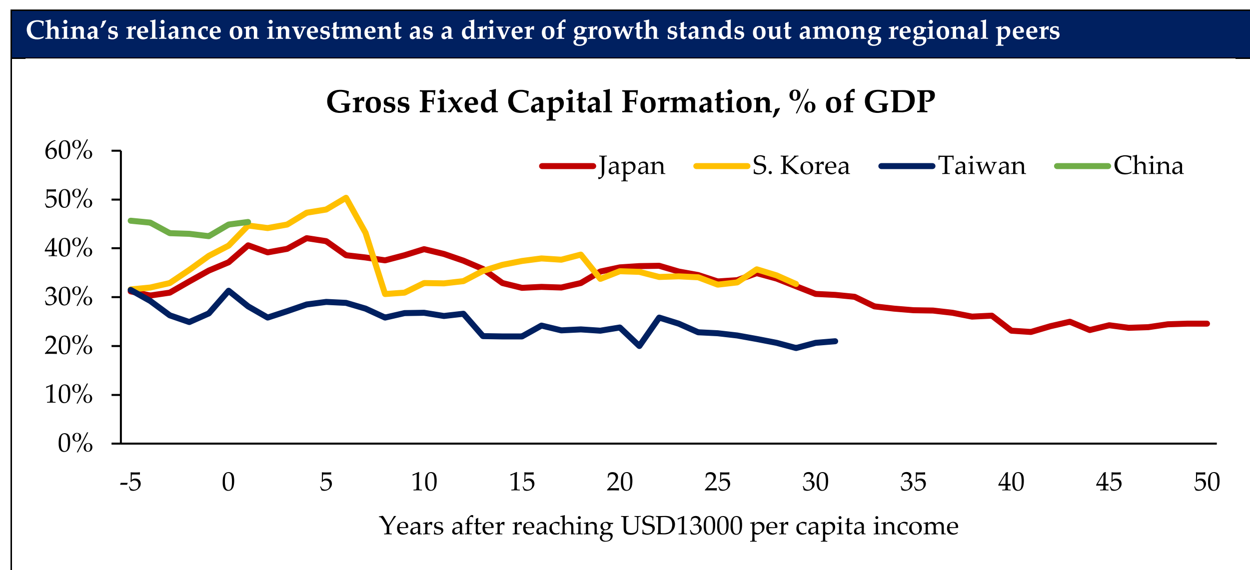
Source: National Bureau of Statistics

[8] Pettis (2021) *What Does Evergrande Meltdown Mean for China?*

Altogether, these factors suggest that investment can no longer do the heavy lifting it once did in keeping Chinese growth afloat. In short, policymakers drove the economy into overdrive via overinvestments and excessive leverage to mask the slowdown in factor productivity growth, providing an illusion that headline growth was still healthy. However, this was essentially "borrowing" growth from the future without necessarily ensuring that the resultant assets could pay for the debt bills which now need to be repaid.

Comparing the situation with other advanced Asian economies shows how starkly China's investment reliance stands out. Japan and Taiwan did not have such high investment-to-GDP ratios at their equivalent stages of development, and even then underwent a multi-year process of gradual adjustment towards a consumption-driven economy, in line with the experience of most advanced markets in Europe and America. The example of South Korea is perhaps the most concerning; having ramped up investment share that is similarly high as China's today, the correction in the aftermath of the 1998 Asian financial crisis and the upheavals experienced by the *chaebols* was a precipitous one. The lesson from economic history is thus clear, the correction can be a "soft" landing or a "hard one".

China's reliance on investment as a driver of growth stands out among regional peers



Source: Centennial Asia Advisors calculations based on Penn World Tables

A world less conducive to sustained, rapid growth due to geopolitical tensions

We have examined the main components of growth (population, productivity, and investments) above and found that China already faces difficulties in maintaining its prior economic performance. What makes its prospects even more challenging is shifts in the qualitative enablers of growth, such as global openness to trade, shifts in investor and consumer behaviour, and the quality of policymaking in Beijing, which have also deteriorated. The world which enabled other advanced economies to escape the middle-income trap, as well as China's rapid exit from low-income status, is no longer available.

In the current phase of US-China competition, it is easy to forget that the "golden era" of friendly relations with Washington and other advanced markets, to paraphrase then UK prime minister

David Cameron, was as recent as 2015. This was a vital ingredient to China's earlier growth; it is hard to imagine China enjoying the success it had without the WTO accession granting it access to global markets, or the resultant inflow of foreign investments that trade liberalization enabled.

The shock Trump presidency in 2016 then started the process of what we now refer to as "de-risking", a policy that Biden is pursuing equally vigorously, albeit with less abrasiveness. The channels that hamper Chinese growth are twofold: firstly**, access to export-driven growth** and the **indirect benefits to productivity and investments**.

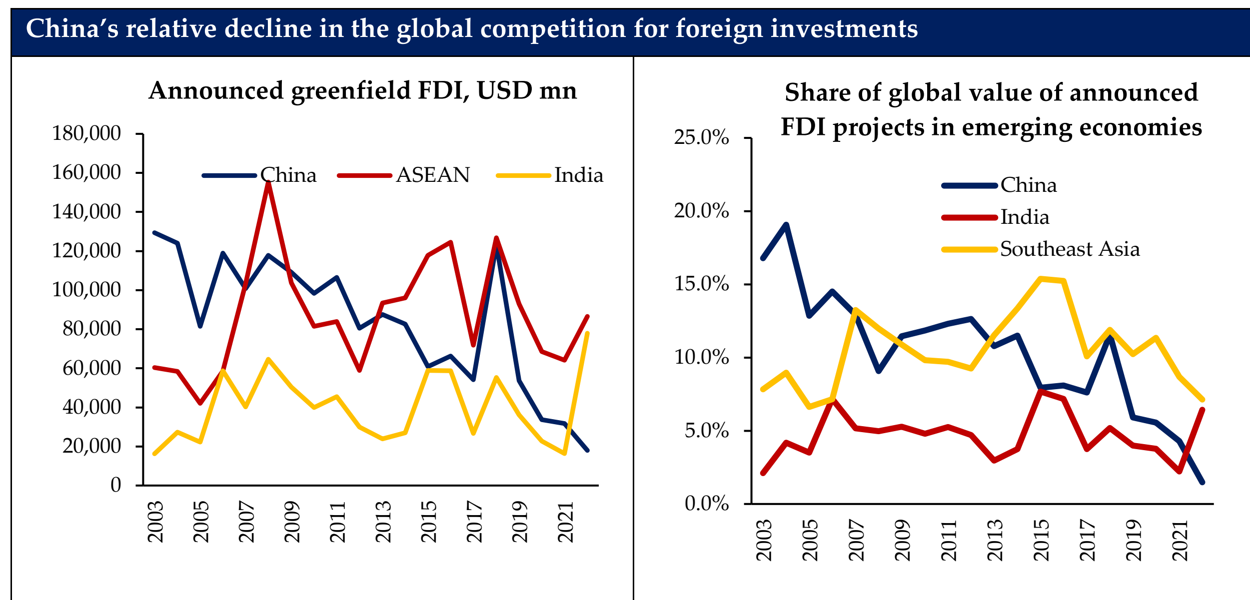
First, consider the reduced access to export-driven growth. Even as domestic demand faces headwinds from demographic headwinds and still-depressed consumption, international consumer markets are also being gradually closed off as importing jurisdictions take a more hawkish stance towards Chinese imports as they realise that their trade deficits vis-à-vis China are no longer politically or economically sustainable. In a reflection of how far the West has turned hawkish towards China in a short span of six years, while Trump's initial tariffs in 2018 had been met with much criticism from businesses and politicians alike, Biden's 2024 announcement of massive tariff hikes on a range of Chinese imports from strategic sectors was received with bipartisan acceptance. In the words of US Secretary Janet Yellen, China is simply "too large to export its way to rapid growth." Beyond geopolitical rivalry, a similar turn towards protectionism is also taking place in emerging economies which have long enjoyed a symbiotic relationship with Chinese producers. Despite benefitting from Chinese investments and commodity purchases, Mexico, Chile and Brazil have all ramped up tariffs on Chinese steel products as China's industrial overcapacity is causing these commodity-exporting countries to be unable to compete in downstream sectors where most of the value-adding is found.

As the potential for export-driven growth diminishes, the reduced spillovers of knowledge and technology from de-risking will arguably exact an even larger cost on China's growth ambitions. Washington's ongoing attempts to curb China's access to advanced semiconductors is one out of many examples of this, other more subtle measures such as restrictions on Chinese-nationality scientists working in sensitive science and technology research, or enhanced screening of Chinese students seeking to study these subjects are also being imposed by other countries. Even if China's internal capacity for technological self-reliance has improved, it is hard to imagine that the loss of cross-border scientific collaboration would not harm long-run innovation and productivity; productivity spillovers from the US and other advanced markets have contributed 0.2-0.35% of GDP via higher productivity[9]; given China's lacklustre productivity growth, the loss of the positive externalities will be a further blow.

These dynamics are further accelerated by the ongoing movement to relocate supply chains away from China to alternative markets, most notably South and Southeast Asia, as evidenced by the flow of global investments to the latter two regions. There are two broad motivating factors. Firstly, some of China's traditional advantages, most notably a labour cost advantage, no longer hold due to population and labour market changes in the economy. Furthermore, firms are

[9] Cerdeiro et. al. (2021) *Sizing Up the Effects of Technological Decoupling*

observing the current moves towards more hawkish foreign economic policy in trade, investment, and technology towards China and deciding that their commercial needs are no longer best served by reliance on China-centric supply chains. Even if they maintain a downscaled presence in the country, the degree of beneficial spillovers of productivity, know-how, and technology will likely be much diminished.



Source: UNCTAD WIR 2023

Is the Chinese system well-configured for growth beyond middle-income status?

Given the above challenges, a key question is whether the policy regime in China is conducive to the transition towards higher-level growth. While China’s strong and centralised state control may have helped pave the way for its earlier successes, growth beyond the low-hanging fruit arguably requires quality governance and institutions that are typically associated with the advanced economies such as the rule of law and checks on executive power.[10]

The recent years following the COVID-19 pandemic were a demonstration of this; Beijing’s policymaking structures have tended to produce large and unpredictable swings in policy, with the abrupt lifting of zero-covid restrictions being but one example. While there may have been sound reasons for the regulatory crackdowns on the housing, technology, and education sectors, some damage on the psyche of Chinese entrepreneurs and consumers seems to have resulted. Rightly or wrongly, there is a concern over the increased influence of ideology on policy making. This has been compounded by a degree of opacity in the economy, as exemplified by the pausing of the publication of unflattering youth unemployment data in 2023 and the indefinite suspension since 2024 of the prime minister's press conference at the end of the National People Congress,

[10] Pritchett and Summers (2014) *Asiaphoria Meets Regression to the Mean*. The authors argue that excluding city states and oil producers, high-income economies are generally democracies. China would thus be a massive outlier if it manages to achieve high-income status without democratic transition.

one of the rare occasions for the public to assess the premier and his messaging beyond well-rehearsed rhetoric.

The combined effect of these is a policy ecosystem that may not be optimally configured to manage an economy with immense scale and complexity; tradeoffs in policy have thus become harsher, and as we argue later are a cause for worry for the future of Chinese economic reform and development.

SECTION 3: TOUGH REFORMS NECESSARY TO SUPPORT FUTURE GROWTH

The challenges facing the Chinese economy in the coming decades are thus daunting and we have argued that its position is worse than other Asian high-income markets at their earlier stages of development. It is the case that there remains considerable scope for some additional catch-up growth; living standards are still less than half the OECD average. We argue, however, that fully capturing these gains is unlikely under the policy status quo. Significant shifts in Chinese economic strategy are required to ameliorate the secular forces that will induce slower growth, or at the very least soften the transition towards the low-growth equilibrium moving forward. We do not claim originality given that the literature in this area is well-trodden but argue that the likelihood of the needed reforms being pursued is relatively low given the economic and political constraints.

Regearing the economy towards supporting consumption will be a painful process

Any credible attempt to set China towards sustained growth going forward will first need to address the "original sin" of the 2010s strategy of investment overreliance. The scale of China's overinvestments, relative to its consumption, is astounding: despite consuming just 13% of global output, China accounts for 32% of global investment and 30% of manufacturing. Such economic imbalance is the natural outcome of a developmental strategy under which income is transferred from the demand side of the economy to the supply side through measures such as low interest rates, state-directed credit and weak social safety nets[11]; consequently, growth in household income has long trailed productivity growth, resulting in Chinese households being unable to afford much of what they produce. By one estimate, for China to continue to grow at a modest rate of 4-5% in the next decade while maintaining its export-led structure, to prevent global overproduction the rest of the world must allow its manufacturing share of GDP to fall by between 0.5 to 1.0 percentage points[12].

As we have discussed, that will be neither politically nor economically acceptable for the rest of the world, especially given the rising enthusiasm for industrial policies in advanced and emerging economies alike. Thus, the solution to sustainable growth will require that investment growth be managed downwards while allowing consumption to grow at a faster pace. Only when there is more "indigenous" demand from household consumption can the imbalance between now-excessive capacity from the elevated capital stock and the depressed household demand be ameliorated. Beijing itself has long paid lip service to this notion, with various party and government bodies calling for policy to prioritize domestic consumption.[13]

The scale of the required change, however, will require undoing years, if not decades, of prior economic policy and will involve a combination of economically painful and politically inconvenient measures.

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[11] Pettis (2024) *China's problem is excess savings, not too much capacity*
[12] Pettis (2023) *What will it take for China's GDP to Grow at 4-5 Percent over the Next Decade?*
[13] Ma, Roberts, and Kelly (2016) *A Rebalancing Chinese Economy: Challenges and International Implications*

Decelerating investments towards a more manageable level (without relying on inducing a large-scale financial crisis as happened elsewhere in Asia), will require undoing the regulatory favours that state-affiliated firms and sectors have enjoyed, most notably through banking sector liberalization to undo the financial repression that enabled the rapid investment growth. Beijing will also need to contend with resistance from vested interests in the incumbent sectors; this has been a barrier to earlier reform efforts under the Hu Jintao administration.

However, given the geo-political challenges, China feels an understandable and urgent need to transform its industrial system into one that is technologically self-reliant and so less vulnerable to external shocks and politically motivated pressures. However, the oft-repeated emphasis on "new productive forces" and "high quality development" has raised concerns in some quarters that they will provide the cover for wasteful industrial policies.

The task of boosting consumption is not straightforward either given the long-standing barriers. The household savings rate in China (hence income not consumed) is among the highest in the world, estimated at 35%; high not only by global norms but even by East Asia standards. The savings rate will likely remain elevated. The property price slump has had severe negative wealth effects in China. Growing economic uncertainty could also persuade Chinese households to continue saving more to rebuild their savings.

Another factor propping up household savings rates is China's ageing which is unfolding in the context of relatively weak social safety nets. Successfully convincing households to save less will necessitate a seismic shift in policies towards a stronger social net. The numbers, however, are far from encouraging: In 2016 China spent just 0.5 per cent of its GDP on social assistance, much lower than the average of 1.5% among upper-middle-income countries to which China belongs[14]. At least in the foreseeable future, an egalitarian transition is handicapped by political resistance; President Xi has strongly criticised welfare-boosting policies as likely to breed laziness. The dreadful state of local governments' balance sheets, only worsened by the difficulty of selling land to developers to raise revenues, further makes social protection and redistribution fiscally challenging.

Furthermore, the descent of investment growth may well harm income growth due to the outsized role that the prior investment drive has had on labour demand and income growth. [15] Having kicked the can down the road, it is hard to envision this process playing out without a significant slowdown in growth and other negative consequences on economic and social stability.

Hukou liberalisation is long overdue and may yield major productivity gains...

One area where there remains a significant gap that can be closed vis-à-vis advanced economies is to utilise urbanisation as an engine of growth. Urbanisation rates in China are still around 15% lower than OECD averages, in contrast with other development-related metrics (lifespan, access

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[14] World Bank Human Capital Project (2020) *Human Capital Index 2020*
[15] Pettis (2023) *Can China's Long-Term Growth Rate Exceed 2–3 Percent?*

to utilities, educational attainment etc.) where China has achieved convergence. Improving both the scale and depth of urbanization could thus provide additional support for growth.

The main inhibitor in this respect is the *hukou* system of household registration, which ties Chinese citizens to specific localities and restricts where citizens can receive public services such as social security, credit, and education among others. This is a major barrier to internal labour market mobility; while there is little stopping a poor worker in the northern Malaysian state of Kelantan to obtain quality employment in the capital city of Kuala Lumpur, the *hukou* system "locks" rural Chinese to their original hometowns; migration in search of opportunities comes with the cost of losing access to the aforementioned public services. Lifting these barriers could allow more flexible internal labour markets, allowing the shrinking working-age population to be better allocated across the economy while also providing an avenue for improving the quality of life for Chinese citizens by enabling improved access to public services.[16]

…but the moves observed so far are half-hearted at best

There have been some recent moves towards liberalizing the system, such as Zhejiang's move to open up *hukou* registrations across the province except for the provincial capital of Hangzhou. Beijing is also giving some degree of tacit support for such moves, with the central government making repeated public admonishments to local governments to abolish or relax *hukou* restrictions in small and medium-sized cities. However, with the reforms so far being conducted in a piecemeal way and lacking nationwide coordination, the results thus far have fallen short of already-modest targets set by policymakers.[17] Coupled with subdued job opportunities in the cities, particularly in construction as the property investments cool, the number of migrant workers returning to their rural hometowns to work in the primary sector thus increased in 2022 for the first time in two decades.

Once again, the political and economic barriers to substantial *hukou* liberalization are daunting, as shown by the slow progress in reform despite the problem being well-known for over a decade. Provincial leaders in the urban megacities have been resisting opening up to rural-origin migrants, both on fears of an inability to finance the additional demand for services, as well as class prejudices based on socioeconomic inequities. While some of this resistance is attributable to vested interests, there is a rational element to this; given the vulnerabilities in local government finances, the additional demands on public services following liberalization may be a source of fiscal strain. Unless more root-and-branch reform of the fiscal system, including decentralization of revenue collection, are also instituted, the prospects for *hukou* reform are dim beyond the marginal tweaks that we are seeing now but have yet to move the needle substantially.[18]

[16] Song (2021) *Cost-Benefit Analysis of the Hukou Reform: Simulation Evidence From a Theoretical Labor Market Model*
[17] Storey (2023) *Is China Finally Getting Serious About Hukou Reform?*
[18] Lu (2023) *China's Local Government Credit Dilemma*

Foundational reforms to China's political economy cannot be dodged forever

The two above reforms are only the most salient in a long list of policies that Beijing needs to undertake if it is to improve long-run growth prospects. Without downplaying the admirable progress made on many fronts, the list of potential reforms to boost business and consumer dynamism remains a long one. Improving the tax and benefits system by enhancing progressivity, reform in state-owned enterprises, undoing financial repression, and broader microeconomic reforms are necessary if private sector dynamism can be restored and directed towards driving China's next stage of growth.

Such a shift, however, will require a rebalancing, if not an outright loosening, of the role of the Chinese party-state in the economy. The centralized approach that enabled the efficient utilization of the country's resources towards early-stage growth needs to start making way for a more decentralized, market-driven approach where the forces of creative destruction are allowed to take their course while managing the downsides via strengthening the government's role as an insurer against dislocations. Even if a conventionally defined liberal democracy is not on the cards, some form of political reform will be necessary to enact these changes. However, Chinese politics and governance have arguably deteriorated under Xi's leadership. Xi's consolidation of power at the 20th Party Congress has multiple implications that may potentially hinder and destabilise future growth patterns. A one-man-dominated system and the suppression of dissent and open exchange of ideas deprive the system of checks and balances necessary for critical self-examination or the correction of policy errors and miscalculations.

CONCLUSION: "JAPANIFICATION" IS AVOIDABLE IF REFORMS ARE UNDERTAKEN

Pulling together the various themes from the above, we come to the following conclusions.

First, the core of the challenge China faces is that an economic model that produced astounding achievements has bequeathed an economic structure that now inhibits China's ability to sustain superior economic performance.

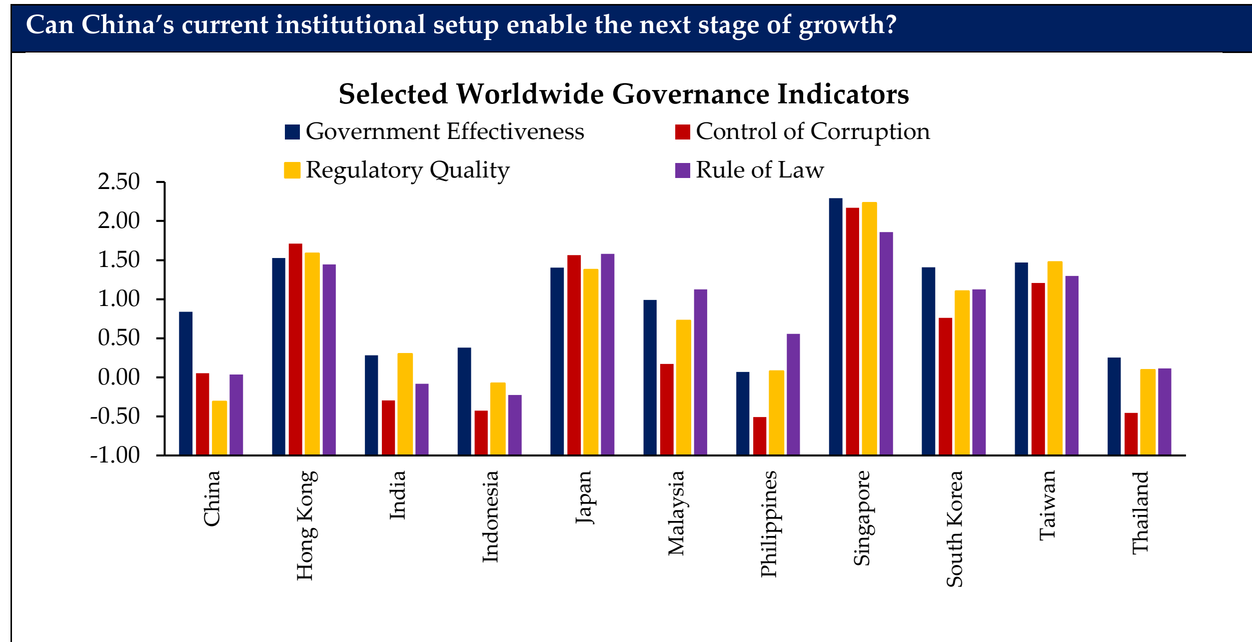
- By ramping up the investment/GDP ratio to extraordinary levels in previous decades, China borrowed growth from the future. Having grown extraordinarily rapidly in preceding decades, it is now payback time and China has to grow more slowly now.
- This is because the unusually high investment rate also came with some downsides. The law of diminishing returns and growing over-capacity in many industries has depressed capital productivity and rates of return. Lower rates of return and increasing uncertainty about policies regarding private businesses are tending to depress private sector investment rates as a result.
- In addition, much of the previous burst of investment was funded by debt. Combined with lower returns on investment, that leaves highly leveraged entities such as state enterprises, local governments and the private sector struggling to repay debt and unable to sustain a high investment rate.
- The previous economic model also left China with a trade structure that is difficult to sustain given the more hostile geo-political environment and the greater concerns in major economies about preserving manufacturing capacity and protecting supply chain resilience. As discussed above, China simply cannot continue to consume just 13% of global output while accounting for 32% of global investment and 30% of manufacturing capacity. It is also untenable for China's share of world exports to continue rising whereas its share of world imports is flat or declining slightly.

Second, what is needed is for China's policy settings to be recalibrated to address these issues. To some extent, this is happening. The authorities have reined in corruption, slowed the build-up of debt and cooled the real estate sector which had become unhealthily dominant in the economy. They have done so even at some cost to economic growth and have demonstrated an ability to prevent the resulting headwinds from causing excessive damage to the economy. Its pivot to new industries such as electric vehicles, solar energy and batteries is proving to be remarkably successful and reflects the benefits of long-range thinking.

But policy reforms have not gone far enough. As we point out, key areas that require reforms such as the *hukou* system and boosting the role of private consumption spending in the economy have not been addressed. The perception of a growing ideological tinge in policy making may have depressed the animal spirits of private entrepreneurs.

Concluding with an international perspective, a survey of Asian economies shows a strong positive correlation between various indicators of governance quality and economic

development. China has thus far grown without the benefits (and to some extent, the constraints) of advanced-jurisdiction institutions. Whether it can continue to be a global outlier in this regard is the key question that will determine its economic and political prospects.



Source: Worldwide Governance Indicators, the World Bank

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