

## Box A: China's slowdown is structural

By Saul Eslake<sup>1</sup>

### Background

China has directly contributed one quarter of the growth in global GDP (as measured by the IMF at purchasing power parities) thus far during the 21st century. But its trend growth rate has unambiguously slowed over this period, from an average of over 10 per cent per annum during the first decade to an average of just under 6½ per cent per annum over the past decade. And it seems set to slow further over the coming decade. This is likely to have important consequences for the growth trajectory of the world economy mainly as a matter of arithmetic, rather than economic theory.

The growth rate of a country's real GDP can be entirely explained 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. China's rapid growth between 1979 and 2010 (some 10 per cent per year, on average) was – as depicted in Figures 1 and 2 – the result of:

- Fairly rapid growth in its population, averaging 1.4 per cent per year up until 1995, after which it slowed to 0.5 per cent per year between 2000 and 2010;
- An increase in the employment-population ratio of almost 11 percentage points (from 47.4 per cent in 1979 to 58 per cent 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 cent per year over the entire period.<sup>2</sup>

Over the past decade, however, China's economic growth rate has slowed – to an average of 7¼ per cent 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 cent 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 per cent by 2019 (largely reflecting the increasing proportion of the population who are now retired).
- Average hours worked have remained stable, at around 41.8 per week; and
- Growth in labour productivity has slowed, from over 8 per cent per year at the beginning of the decade to an average of 6½ per cent per year between 2017 and 2019 inclusive.

The short-but-sharp recession induced by the onset of Covid-19 in the first quarter of 2020, the subsequent rebound in economic activity in the middle of 2020, and the ensuing ebbs and flows associated with natural disasters, power shortages and recurring virus outbreaks (including the most recent one) complicate the interpretation of these metrics over the past three years.

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).<sup>3</sup> 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 per cent 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. For the

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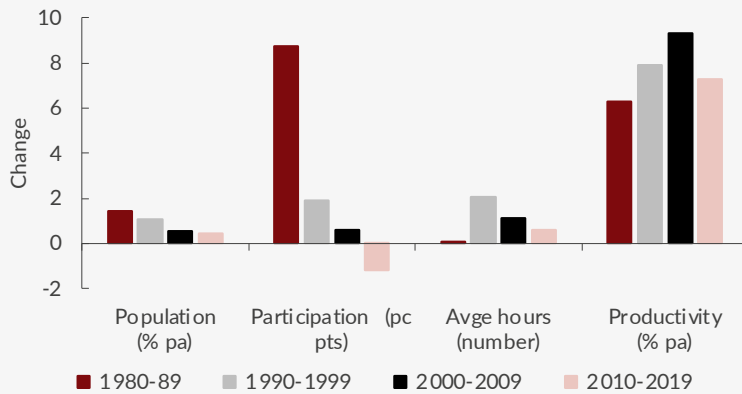
2 These figures, and those in the following paragraph, are derived from the Conference Board's Total Economy Database (August 2021 edition), using the 'official' series for real GDP.

3 See United Nations Department of Economic and Social Affairs, 2019 Revision of World Population Prospects.

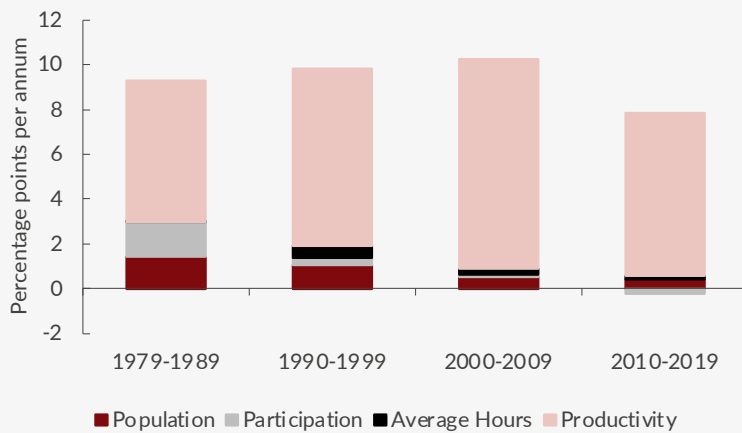
same reason, average hours worked are unlikely to increase (not having done so over the past 15 years) and may well decline – especially given increasing public antipathy and regulatory hostility towards the so-called ‘996 culture’ (working from 9am to 9pm, six days per week).

Whether China can sustain economic growth at the (lower) 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.

**Figure A1 Drivers of Chinese real GDP growth, 1979-2019**



**Figure A2 Contributions to Chinese GDP growth, 1979-2019**



### 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.

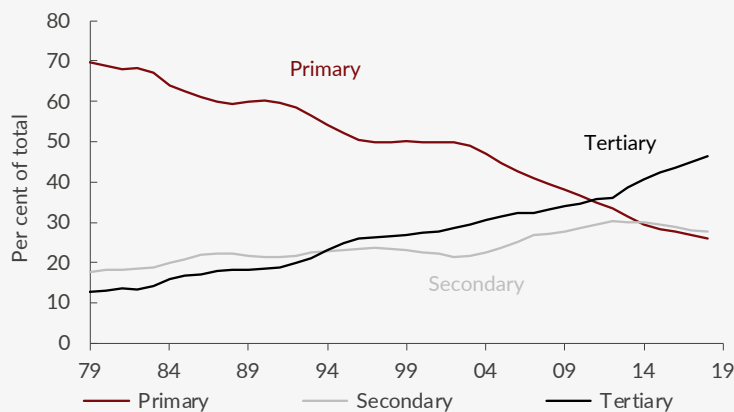
Although labour productivity (measured, unavoidably crudely, by GDP per person employed) in Chinese agriculture has improved dramatically over the past 40 years, it has always been less than one-quarter (and usually less than one-fifth) of that in manufacturing. So the decline over this period in the proportion of

China's workforce employed in primary industry, from 70 per cent in 1979 to 26 per cent in 2018 (still the latest year for which data are available) – and the corresponding increase in the proportion employed in secondary and tertiary industries from 18 per cent to 28 per cent, and from 12 per cent to 46 per cent, respectively, has been a crucial factor in China's ability to sustain its extraordinarily rapid rate of economic growth for so long (Figure A3).

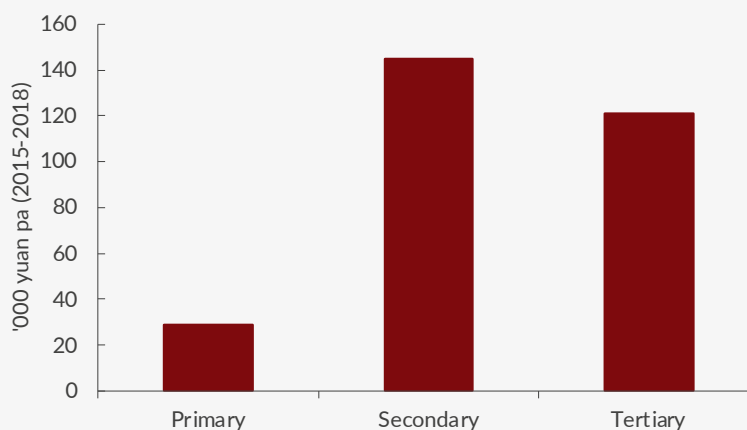
However, the scope for further reductions in agriculture's share of economic activity and employment is now much more limited. Moreover, manufacturing's share of GDP peaked at around the time of the global financial crisis, and its share of total employment in the early 2010s. Almost 60 per cent of the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

And because labour productivity in services is about 16 per cent lower than that in manufacturing (see Figure A4), the likely continued growth in services as a share of total economic activity will (all else being equal) detract from overall productivity growth.

**Figure A3** Sectoral composition of employment in China



**Figure A4** GDP per person employed, by sector, 2015-18



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

The first is the new 'Dual Circulation Strategy' first laid out by China's President Xi Jinping in May 2020 and

formally adopted as part of the 14th Five Year Plan at the National People's Congress in February 2021<sup>4</sup>. 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 (in 2021) for more than 15 per cent of total world merchandise exports, compared with less than 1 per cent in 1979 and less than 4 per cent 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.

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'.<sup>5</sup>

While efforts to reduce inequality need not detract (and indeed can enhance) overall economic growth,<sup>6</sup> the particular nature of China's regulatory crackdown has already resulted in significant dislocation of the targeted sectors,<sup>7</sup> and may well reduce the pace of innovation and hence productivity growth.

## A farewell to leverage

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 per cent of China's GDP in the second half of 2008 to 285 per cent of GDP by the third quarter of 2021 – 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 A6).

More than half of that debt (equivalent to about 155 per cent 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 A5).

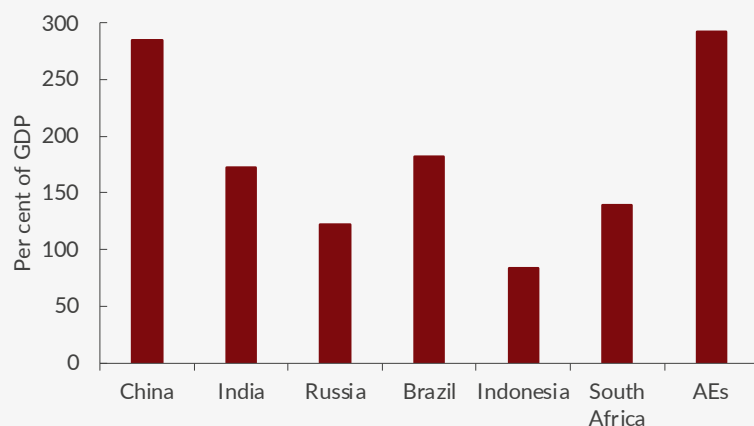
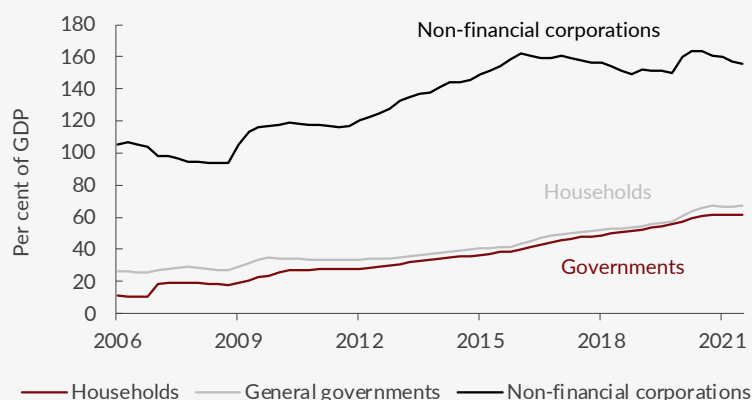
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4 See e.g. Alessandro Bazzoli, 'China's Plan for the Post-Pandemic World Order: The Dual Circulation Strategy', Global Risks Insights, 30 April 2021; or Lin Justin Yufu and Xiaobing Wang, 'Dual Circulation: a New Structural Economics view of development',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

5 For an official explanation, replete with references to 'strengthening the "four consciousnesses", firming the "four self-confidence" 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".

6 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.

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

**Figure A5** Credit to non-financial sectors, Q3 2021**Figure A6** Credit as a proportion of GDP by sector, Q3 2021

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.<sup>8</sup>

In August 2020 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 per cent, 100 per cent 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.

It is particularly notable that, unlike every 'advanced' economy and almost every other 'emerging or developing' economy, China has consciously eschewed any wide-ranging 'unorthodox' monetary policy measures in order to support economic growth. 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.<sup>9</sup>

8 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.

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

## 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 – but maximizing GDP growth is not one of them. The most recent meeting of China's National People's Congress (China's rubber-stamp Parliament) set a real GDP growth target of 5½ per cent for 2022 – which, if achieved (something that now looks more doubtful given the likely impact of China's continuing 'zero tolerance' approach to Covid-19 in response to the most recent virus outbreaks) would be the lowest growth rate in 40 years, other than the 4.3 per cent and 4.1 per cent recorded in 1989 and 1990, respectively.

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