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China in the 2020s: a more difficult decade?

GEORGE MAGNUS

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INTRODUCTION

The occupants of Zhongnanhai–the central headquarters of the Communist Party and the State Council in Beijing–might have wished for a better 'Year of the Pig'. The trade war with the United States through 2019 has escalated into an existential struggle defined on both sides by words such as 'containment' and 'decoupling'. And even though China's economy has stabilised after a sharp slowdown in the 2018/19 winter thanks to new stimulus measures, it is still fragile and faces important structural challenges in the next few years that could have pronounced political implications.

An unusual outpouring of dissent and criticism at home about the path and policies that Xi's China has chosen has become more prevalent. Pushback abroad, not least in Hong Kong, also poses awkward issues for the government. One leading expert on the Chinese Communist Party has even argued that Xi Jinping's overreach may come back to haunt him before the 20th party Congress, in late 2022.[1]

These phenomena are occurring at an important time, as party officials prepare for the 70th anniversary of the founding of the People's Republic on 1 October 2019. China's craving for stability is normal, but especially pronounced now with the unrest in Hong Kong, and in the future ahead of the next major anniversary, in 2021, when it will commemorate the centenary of the Communist Party. These and other official anniversaries are important political events that are about the narrative of the party's historically enabling role and legitimacy. There is no space for instability or threat.

SUCCESSES

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According to the World Bank, the number of Chinese residents living in rural areas in extreme poverty (less than $1.90 a day in 2011 purchasing power terms) had fallen to 700,000 by 2015, compared with over 750 million in 1990.[2] Using less restrictive measures of poverty, China's poor may still be counted in tens or hundreds of millions, but there is no doubt that the government will claim it has ticked an important box of developmental progress.

In 1990, China was still classified as a poor country with income per head of only $348, or just 1.5 per cent of what it was in the United States. In 2019, China's upper middle income status is secure with income per head estimated by the IMF at just over $10,000. This is still only 15.5 per cent of the United States level, but it is nonetheless a remarkable achievement. The pledge to double income per head between 2010 and 2020 has all but been fulfilled. Something quite dramatic would have to happen in the next year for this pledge to fail.

Yet, the party's narrative now faces an important reckoning for two reasons. First, the consequences of its governance system for maintaining stability, control and fealty within its borders and stable political relations outside. Second, its capacity to achieve a persistently high and stable rate of economic growth, currently targeted at about 6 per cent, as a proxy for high rates of employment growth. Indeed, China's growth rate is likely to slide in the 2020s to a more sustainable rate of 3-4 per cent, and there's a sporting chance that China will not become the world's largest economy after all.

In these and other respects, China is increasingly hostage to events, some of which are conspiring against it, including the White House's relentless pursuit of trade policies that have brought China and the United States into conflict, and the upheavals in Hong Kong. The consequences of both will weigh on Beijing policy-makers for some time.

EXTERNAL EVENTS

The American political thinker, Edward Luttwak once described trade conflict between the United States and Europe and Japan several decades ago as 'The logic of conflict is the grammar of commerce'. This turn of phrase could not be more apt for the current state of China-US relations. The trade war is, of course, about trade, but deep down, it is also about China's technology and industrial policies, and the struggle for technological dominance in commercial and military spheres.

In contrast to trade in, say, steel or soyabeans, though, technology is a genuinely global industry, which is China-centric, and features high levels of integration and extensive supply chains that cross national boundaries and connect companies all over the world. It is a systemic industry, not unlike global finance in 2008, fissures within which are likely to have far-reaching implications for China's economy and for the rest of the world.

Against this background, the escalation of the trade war from punitive tariffs to include greater scrutiny over foreign investment, and, in the summer of 2019, the establishment by both sides of so-called 'entity lists' that target companies marked a serious deterioration in Sino-US relations. While China and the US both have opinion formers or officials who still want to rebuild trust and re-establish a viable co-existence, they also have those who favour 'decoupling' and greater 'self-reliance'. For them, the trade war is about politics, specifically about different perceptions of fairness, standards and beliefs.

The trade war had not had a big impact on China's economy until the White House's new tariff measures came into effect in September 2019. Yet, virtually the whole of China-US trade is now subject to punitive tariffs, and economic reports and surveys by some banks suggest that trade conflict is affecting export and industrial firms, and jobs.

The cumulative impact of punitive US tariffs may be to take about 0.75-1.25 per cent off China's economic growth rate over the coming 12-18 months. There will also be secondary effects on the value of the Yuan, and as global and Chinese firms rethink their China-centric supply chains, and look elsewhere for political and policy certainty and the ability to compete effectively.

The Yuan has already slipped back to levels not seen for over a decade, and China will have to pay close attention to its currency for fear that untoward weakness or policy miscalculations trigger additional weakness and the risk of higher capital outflows. Surveys published by large banks and the American and EU Chambers of Commerce in China in 2019 reported that between a fifth and third of companies had already moved some

supply chain operations to other nations, with comparable proportions indicating that they planned to do so in the future.

However the Chinese and US governments manage the trade-specific aspects of their conflict this year or in 2020, the fundamental aspects of their misaligned interests nowadays are most likely to persist, with adverse economic consequences for the foreseeable future.

A more immediate challenge for Beijing is playing out on the streets of Hong Kong, which it would certainly want to see pacified before the 1 October anniversary celebrations. Yet, there is a myriad of reasons why China might not want to intervene directly, even though some observers have raised, for understandable reasons, echoes of the Tiananmen Square protests in 1989.[3]

Hong Kong has a population of 7 million, a larger and far more complicated geography, and a people who have familiarity with the rule of law and democratic institutions, and resent local dysfunctional government and restricted opportunity. Although Hong Kong is small in the context of China's $13 trillion economy, it still packs a powerful punch in terms of financial services. It is the mainland's window to global finance and vice versa. It is still a rule of law territory, famed for the quality of its regulatory oversight, low taxation, and free movement of capital, and for the talent that has flocked there to build the most mature and sophisticated money and capital markets in Asia.

It is a crucial conduit of foreign capital into Chinese securities markets, especially of foreign borrowing in US dollars on which China is becoming more dependent, and of inward foreign investment. Almost half of inward investment into China comes from Hong Kong as Chinese firms use the advantages enjoyed by Hong Kong as a base from which to invest in the mainland. The local stock exchange may now be dwarfed by the exchanges in Shanghai and Shenzhen, but its capitalisation is still the fourth largest in the world, and the third largest in Asia, after China and Tokyo. About half the companies listed on the exchange are mainland companies, which raised more capital there in 2018 than firms did on Wall Street.

If, as seems likely now, Hong Kong loses its prized status, direct intervention or not, China is at risk of losing many ancillary services that make finance for China's enterprise and investment work, such as law, capital raising, securities structuring and trading, accounting, and fintech.

In any event, the signalling impact of developments in Hong Kong to voters in Taiwan, which holds presidential elections in January 2020, is already important. Opinion polls indicate a rise in support for the incumbent President Tsai Ing-wen, whose campaign embraces antipathy to the 'one country, two systems' slogan. If re-elected, Taiwan's political distance from China would increase, and present President Xi Jinping, for whom an important legacy is the

peaceful re-unification of the 'renegade province' with the mainland, with a new and sensitive problem.

China's broader international relations in the 2020s, moreover, are likely to become more challenging as a result of already existing criticism in several Belt and Road countries about corruption, over-charging, lack of transparency and accountability, poor environmental standards, and contentious attitudes and practices. Some Southeast Asian nations are considering the balance between their economic interests with China and their security interests with America.[4] Several countries have re-negotiated or cancelled Belt and Road projects, and President Xi even acknowledged in 2019 that some Belt and Road programmes could now be scaled back or joined by other countries, global financial institutions and financial centres. This may prove difficult to accomplish because the Belt and Road is, in effect, an extension of the domestic model of how banks, state enterprises and local governments do infrastructure business in China. Criticisms are not so much about unforeseen or random errors as much harder governance features.

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MANAGING THE ECONOMY

Under President Xi Jinping's governance regime, China has had to embrace tight party discipline and social control, the suppression of internal dissent and division, the substitution of party cadres and agencies for technocrats and state institutions in the origination and implementation of policy, total control over the communications, academic and legal systems, and a relentless and extensive anti-corruption campaign.

The fear that this regime might end up stifling initiative and creating a more rigid government system leading to adverse economic outcomes is no longer a fringe view. The issue is not so much that economic growth is

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slowing in China, but that the government is trying to sustain unsustainable levels of growth. To this end, there has been a flurry of what we might call 'disquiet' in China, even if open dissent or criticism of President Xi does not really happen and is seen as too risky. The trade war with the United States has certainly acted as a catalyst, bringing to the fore the writings of several notable academics and intellectuals, who have criticised the government for being wrong-footed and unprepared, for losing China's most important external relationship, and, more generally, for risking uncertain and adverse economic outcomes.

Among the more notable criticisms written since 2018 are those of Tsinghua University law professor, Xu Zhangrun, who criticised the abandonment of presidential term limits, and government repression and ideology, and asserted that the government had lost its way in the conduct of both economic and foreign policy.[5] Zhang Weiying, an economics professor at Peking University, charged that the government narrative attributing China's past success and future opportunities to the central role of the Party, the state and top-down industrial policy was wrong. Instead, he argued that China's past and future hope lay in marketisation, entrepreneurship and learning from the rest of the world.[6] Other remarkable critiques have hailed from Professor Sheng Hong of the beleaguered Unirule Institute, who was critical of the government's heavy-handed and party-state approach to intellectual property and to the institutional structures, including the rule of law, on which China's science and engineering future depended.[7] And also from Professor Xiang Songzuo of Renmin University who asserted that the government was not addressing critical shortcomings in the economy's structure, the serial violation of laws and regulations, or the steady demise in the health of the private sector.[8]

While the impetus behind market-oriented reforms has waned in deference to the innate preference for administrative directives, restrictions, quotas, and bureaucratic reforms, President Xi did act at the end of 2018 to offer more support for China's flagging private sector, and back new lending and

business support measures. The messaging, though, remains equivocal because public ownership and state control are also seen as the unquestionable cornerstone of his ‘Socialism with Chinese Characteristics for a New Era.

DEBT

Since the financial crisis of 2015-16, the government has attempted to clamp down on the most egregious forms of financial risk-taking, restrict the use, and abuse, of credit, and has been willing to tolerate slightly lower growth - up to a point. Tougher ‘macro-prudential’ financial regulations in and after 2017 have proven to be quite effective. Total debt as a share of GDP remains high at over 300 per cent, but is now growing more slowly than before. So-called ‘shadow banking’ assets, which amounted to about 87 per cent of GDP in 2017, dropped to about 68 per cent of GDP in 2018. The growth of credit creation, running at about 17 per cent three years ago, had almost halved by 2018, though it has picked up since the start of 2019.

Despite these developments, considerable concerns remain, not least as to whether the authorities have really come to terms with the trade-off between deleveraging and slower credit expansion on the one hand, and slower economic growth on the other. The ratio of debt to income in China is still rising, and while there has been some moderation in borrowing by companies, the debt burdens of local governments, and more recently of households, have been rising steadily. Some of the progress Chinese banks have made in strengthening their balance sheets by raising new capital and writing off some historic bad loans is being undone by weaker growth and new bad loans. Financial instability risks, moreover, are present in the risky ways in which banks fund their loans in short-term interbank and other financial markets, rather than from more stable household and company deposits. This is especially true of joint stock, city commercial and rural banks that account for about 45 per cent of banking system assets.

Two such banks, Baoshang Bank and Bank of Jinzhou had to be bailed out earlier this summer. The former was the first one taken over by the government for 20 years. Even though small, their failure raised deep concerns about balance sheet, counterparts and contagion risks, and while the authorities acted in a timely way, no one can be sure that this will always be the case. It is widely acknowledged that even absent a crisis, restructuring and recapitalising the banking system and weaning the economy off debt-dependency will take several years and result in significantly lower economic growth.

DEMOGRAPHICS

A longer-term challenge for China is rapid and premature ageing. Because of the interplay between weak fertility rates and rising life expectancy, a now common global phenomenon, the working age population is being hollowed. It started to drop in 2012, and the decline will gather pace in the 2020s. By 2050, the working age population is predicted to fall by over 210 million, a drop of over 20 per cent.

Because the retirement age for men and women is so low (60 for men and 50 or 55 for women), China's old age dependency rate (retirees as a share of the working age population) is going to soar in the next 20-30 years. Put another way, today there are about 7 workers for each retiree, but by the 2040s, this will have fallen to 2.5 workers, lower than it is predicted to be in the US. This phenomenon, unless mitigated, is associated with worse economic outcomes for growth, productivity, and the financial well-being of individuals, especially pensioners, and the state.

The weakness of the fertility rate is the key factor, as it is elsewhere. This has prompted the government to not only use rhetoric such as 'have children for the country' but to look at extensions to periods of maternal leave, and to financial incentives to encourage couples to have second children.

Yet these methods aren't working. After 17.86 million births in 2016, the figure dropped to 17.2 million in 2017 and 15.2 million in 2018 – the third lowest rate after 1949 and the 1960–61 famine. Lower fertility trends in China do not seem any more likely to reverse than in other ageing nations, not least because of rising income per head which is strongly associated with low fertility, and because of the steady decline in the population of women of child-bearing age. The situation may be even more alarming and urgent than mainstream demographers estimate. The fertility rate is officially estimated to be 1.6 children per woman, but one expert on fertility trends thinks it could have been as low as 1.18 on average between 2010 and 2018.[9]

Either way, the combination of weak fertility and rising longevity means that China will age as rapidly in the next 22 years as most western countries have done over 50-75 years, and with much lower levels of income per head and far less sophisticated social programmes. Demography in the 2020s will accentuate for China what is already a complex economic outlook, and challenge its leadership to introduce innovative coping mechanisms, such as more accessible and cheaper childcare, a reversal of falling female labour force participation, higher retirement ages, accelerated opening of services, wealth redistribution and better social safety nets, hukou reform, and ultimately higher productivity growth and immigration.

MIDDLE-INCOME TRAP

Another important challenge for China's leaders in the coming years will be to avoid what economists call the middle-income trap, a concept describing the tendency for most countries that have grown out of poverty to stall in relation to their rich peers when they achieve middle income status. Premier Li Keqiang has often opined on this problem but with confidence that China will avert it. Yet, assurances are no substitute for the reasons that cause countries to become trapped. These revolve not so much around the capacity to innovate or accomplish meaningful science and engineering feats, as the risk of a failure of governance and in the development of inclusive and robust institutions. In other words, it is about the willingness of political elites to implement policies and reforms designed to realise long-term improvements in productivity.

Empirical evidence in China demonstrates a strong correlation between periods when market-oriented reforms have been pursued with enthusiasm and high or accelerating productivity. These periods occurred in the 1980s, the early to mid-1990s, and again in the years preceding and following accession to the World Trade Organisation. In the last decade or so, the growth in what economists label total factor productivity has been no better than pedestrian, and of late, it has almost certainly stalled. According to most western thinking, the governance system in Xi's China is not really compatible with the kind of institutional and political changes deemed necessary to jump the middle-income trap.

China, on the other hand, doesn't see it this way. In fairness, it may prove to be the first state-run, illiberal and authoritarian country to confound our thinking about how to avoid the middle-income trap. Yet, the chances of success do not look persuasive, and the 2020s are likely to settle the argument one way or another.

THE FUTURE: A MORE DIFFICULT DECADE FOR THE WORLD'S SECOND ECONOMY

At the dawn of a new decade, and ahead of the centenary of the founding of the Chinese Communist Party, China has much to look back with pride and satisfaction. Yet, since Xi Jinping came to power, much has changed inside and outside China, suggesting that the 2020s for will be more unsettled economically, and even, brittle politically.

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At home, the government's attempts to maintain economic growth at an unsustainable level are already lacking traction because of the economy's more limited capacity to carry and service high levels of debt. The confluence also of rapid ageing, a looming middle income trap, and potential currency or financial instability will sap China's growth, and employment-generating capacity.

Externally, China faces a much more hostile economic environment as the US-China relationship goes through an unpredictable re-set, and as far as trade, and cross-border investment are concerned. Self-reliance may make for a good slogan, but the reality is that China remains highly dependent on US aggregate demand and technology, and the globalisation status quo.

The conventional narrative is that China is, or will, by 2030, be the largest economy in the world. Based on commonly held expectations historically about prewar Germany, the USSR and Japan, greater humility would not go amiss. It is not preordained that past economic trends will continue, especially in view of a much compromised outlook for both China and the rest of the world in the 2020s.

China is certain to experience slower economic growth in the years ahead, but the bigger surprise may be that, in US dollar terms, this narrative could be a factoid because of a fault-line that leads to a precipitous fall in the Yuan.

The Yuan is semi-pegged to the US dollar, but this relationship is only stable in the medium-term if monetary policy keeps the growth of domestic assets in a tight relationship with the growth in foreign currency reserves. Otherwise the excess of domestic liquidity might seep abroad and overwhelm the reserves. In China, domestic liquidity is growing at about 10 per cent per year, while reserves are stable or as some believe, masking persistent capital outflows. If these trends continue, it is quite likely that the Yuan semi-peg will snap in the next few years. Emerging country experience informs us that when this happens, typical depreciations are 20-40 per cent, and invariably followed by a recession. A fall of this magnitude would keep China's GDP, measured in US dollars, firmly below that of the US. We should not be surprised, therefore, if China's GDP relative to the US in 5-10 years is not so different compared with what it is today.

In that event, the perception of China's relative position and prospects in the world would be quite different from what is now presumed. China itself might be more inclined to focus on the key enablers of higher productivity, and living standards, and environmentally and commercially sound public spending. Governments, corporate strategists, and international relations analysts, would have to re-examine their assumptions and implications about China's narrative and trajectory. ■

NOTES

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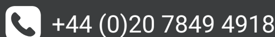 +44 (0)20 7849 4918

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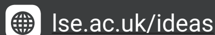 lse.ac.uk/ideas

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